



The Rising *of the* STATES *in* Nonprofit Oversight

by Lloyd Hitoshi Mayer

WHILE THE IRS'S ROLE VIS-À-VIS NONPROFITS HAS BEEN UNDER FIRE,
THE STATES HAVE BEEN EXPLORING BETTER WAYS TO COLLABORATE ON
IMPROVING THEIR ROLE IN REGULATION AND ENFORCEMENT—
INCLUDING A TEST CASE ON NONPROFIT FRAUD THAT INVOLVED ALL
FIFTY STATES AND THE DISTRICT OF COLUMBIA. TECHNOLOGICAL
ADVANCES WILL FIGURE PROMINENTLY IN THIS VENTURE.

IN AN EXTRAORDINARY DEVELOPMENT, ALL FIFTY states, the District of Columbia, and the Federal Trade Commission filed a federal lawsuit in May 2015 against four charities and their operators, alleging that they had defrauded more than \$187 million from donors.¹ While the dollar amount was staggering, the most unusual aspect of the lawsuit was the incredible level of cooperation among state nonprofit regulators. This cooperation was evident not only in the bringing of the lawsuit but also in its successful settlement less than a year later, with the defendant charities and their principal officers surrendering substantial assets, agreeing to dissolution of the charities, and acquiescing to being banned from fundraising and management of charities and charitable assets in the future.²

This development highlights the growing sophistication and cooperation of state nonprofit regulators. And it is not an isolated incident. Building on seeds planted over the past several decades, state regulators are both individually and collectively increasing their oversight of nonprofits.

This trend is fortunate for those who care about oversight of nonprofits, because it comes at a time when the Internal Revenue Service's efforts in this area are atrophying. Even before the recent controversy related to the handling of exemption applications filed by politically active nonprofits, the IRS faced a tight budget and a growing list of responsibilities, including significant rulemaking

and administrative duties related to the Affordable Care Act, or Obamacare. These pressures, in turn, led to a growing backlog of applications for recognition of exemption, a decline in the already low audit rate for tax-exempt nonprofits, and limited new guidance for nonprofits seeking to comply with the complex federal tax rules applicable to them.³

The mess involving exemption applications filed with the IRS by Tea Party and other conservative-leaning groups worsened this situation in several ways, however. It accelerated the development of streamlined application procedures—including, but not limited to, the new Form 1023-EZ—that significantly reduce the level of IRS review for new organizations. It also gave Congress another reason to underfund the IRS, forced a wholesale change in the leadership of the IRS Exempt Organizations Division, and almost certainly made employees throughout that division wary of pursuing all but the most egregious violations of federal tax law. IRS examinations of annual information returns (primarily the Form 990 series) are now at an anemic level of less than four-tenths of a percent annually. This is at

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LLOYD HITOSHI MAYER is a professor of law at Notre Dame Law School, where he focuses on federal, state, and foreign laws governing nonprofit organizations. Before entering the academy, he practiced with the Exempt Organizations Group at Caplin & Drysdale.

States and localities have also become increasingly active in challenging the often very valuable property tax exemptions enjoyed by many nonprofits. These disputes have involved Princeton University; the Shrine of Our Lady of LaSalette, in Attleboro, Massachusetts; dozens of hospitals; and property owned by numerous other types of nonprofits.

a time when the number of tax-exempt nonprofit organizations has grown to over one and a half million—not including churches and other houses of worship that are not required to seek such recognition from the IRS.

So, what have state nonprofit regulators been doing during this time of decline in IRS oversight? Individually, many of them have been working hard to review and improve their laws and procedures governing nonprofits, as well as increase efforts to reach the regulated community and those who advise that community.

Individual State Initiatives

In the wake of the Enron disgrace and other scandals that rocked the for-profit sector, California enacted the Nonprofit Integrity Act of 2004 to improve the governance procedures and enhance the filing requirements for charities, other nonprofits that hold funds for charitable purposes, and commercial fundraisers.⁴ Significant new requirements included in the act are a shortened period for registering with the attorney general (thirty days after the initial receipt of property); mandatory audited financial statements and detailed audit-committee requirements for charitable corporations with gross annual revenues of \$2 million or more; mandatory board or board committee review of senior officer compensation; and numerous additional filing requirements for commercial fundraisers.

In 2013, New York enacted the Nonprofit Revitalization Act based on recommendations from Attorney General Eric T. Schneiderman's Leadership Committee for Nonprofit Revitalization, made up of representatives from the New York nonprofit community.⁵ The act sought to relieve burdens on that community by reducing the number of categories for nonprofit corporations under New York law, simplifying certain formation procedures, and increasing revenue thresholds for certain auditing requirements. It also imposed enhanced corporate governance standards—including those relating to conflicts of interest, related party transactions, whistle-blowing, and financial audits—and gave the attorney general increased enforcement authority. More specifically, the act requires a written conflict of interest

policy (with certain provisions for boards of all nonprofit corporations), mandates certain procedures for related party transactions, and requires a whistle-blower policy for nonprofit corporations with twenty or more employees and over \$1 million in annual revenue. New York also recently announced a project to systematically review its registration and financial filing procedures for charities and fundraising professionals.⁶

These efforts are in addition to the increasing availability of state nonprofit filings through Internet-accessible databases, prominent announcements of investigations into alleged wrongdoing by nonprofits, and required annual reports detailing the high fundraising costs of certain nonprofits. On the latter point, examples include California's commercial fundraisers reports, Massachusetts's *Report on Professional Solicitations for Charity*, and New York's *Pennies for Charities* report. In addition, state regulators have been working to enhance the other information available on their websites, providing an increasing number of plain-language guides on topics ranging from formation to fiduciary duties to dissolution. State regulators have also become regular presenters at many conferences focused on nonprofit legal issues, including meetings of the Exempt Organizations Committee of the American Bar Association, Section of Taxation; the Georgetown Law Representing and Managing Tax-Exempt Organizations conference; and the Loyola Law School Western Conference on Tax Exempt Organizations.

At least one state has taken a more innovative approach to combating what it perceives as unduly high fundraising expenses: An Oregon statute now disqualifies charities from eligibility to receive contributions that are tax deductible for purposes of Oregon's income tax and corporate excise tax if program expenses fall below 30 percent of total annual functional expenses for the most recent three-year period. In December 2015, the Oregon Department of Justice announced the first three nonprofits to fall afoul of this rule; it remains to be seen whether any of them try to challenge their disqualification in court.⁷

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property tax exemptions enjoyed by many nonprofits. These disputes have involved Princeton University; the Shrine of Our Lady of LaSalette, in Attleboro, Massachusetts; dozens of hospitals; and property owned by numerous other types of nonprofits.⁸ With no relief in sight for many state and local government budgets, these challenges show no signs of ebbing.

At the same time, state nonprofit regulators appear to have mostly avoided or backed away from getting involved with the regulation of political activity by nonprofits. While California and New York have been particularly active in this area, those states ultimately passed new election laws expanding disclosure of political activity by all types of entities, not just nonprofits, and disclosure of funding sources for such activity.⁹ By doing so, they avoided any need to modify the laws specifically covering nonprofits. In New York, the attorney general actually revoked previously issued proposed regulations that would have targeted for disclosure political activity by tax-exempt organizations, on the grounds that the election law changes made the proposed regulations largely redundant. This is almost certainly a positive development, given the IRS's experience with regulating political activity by tax-exempt organizations, as it keeps this difficult and risky task in the hands of the state agencies that administer state election laws and thus are better suited to oversee such activity. That risk is illustrated by the ongoing litigation challenging California's attempts at requiring tax-exempt nonprofits to submit to the state attorney general the list of donors they file with the IRS. The U.S. Court of Appeals for the Ninth Circuit has upheld on its face the attorney general's ability to demand this information, but a federal district court has barred this demand with respect to one particular, politically active nonprofit: the Koch brothers-funded Americans for Prosperity.¹⁰

Collective State Efforts

State nonprofit regulators have also been increasing their communication and coordination across state lines. While such efforts can be traced back to occasional projects under the auspices of the National Association of Attorneys General

(NAAG), they gained a more formal structure with the launch of the National Association of State Charity Officials (NASCO) in 1979. In particular, NASCO's annual conference, which includes both public and regulator-only sessions, provides an ongoing opportunity for state regulators to meet each other, share their experiences, and learn about new developments. NASCO has also played a critical role in helping develop the Unified Registration Statement for nonprofits engaged in charitable solicitation, and the more recent Single Portal Initiative, which seeks to develop a one-stop Internet platform for charitable solicitation registration and reporting for all states that require such filings. NASCO has also begun to show a willingness to critique IRS oversight efforts—not just behind the scenes but also publicly, as shown by the concerns it recently raised about the new IRS Form 1023-EZ.¹¹

The Single Portal Initiative is a good example of how long it can take for such collective efforts to bear fruit. The Initiative can be traced at least as far back as 2003, when the U.S. Department of Commerce provided initial funds for the project to GuideStar, which was working in partnership with NASCO.¹² Almost thirteen years later, the Initiative published an official Request for Information, seeking input on the pilot website that NAAG and NASCO plan to launch by the end of 2016.

In 2006, the National State Attorneys General Program at Columbia Law School developed the Charities Regulation and Oversight Project directed by Program Executive Director and Senior Counsel Cindy Lott.¹³ The project provides an opportunity for state regulators to gather together to learn about various topics of common interest, including conservation easements, fraud in the charitable sector, and future trends in state regulation of charities. It also supports in-depth research into state regulation and enforcement of the charitable sector, in cooperation with the Urban Institute's Center on Nonprofits and Philanthropy.¹⁴

Finally, NAAG recently formed its Charities Committee, which joins a dozen other NAAG special committees that focus on topics ranging from agriculture to federalism to substance abuse. This move is significant, because it

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institutionalizes attorney general-level attention to the oversight of charities. Consisting of eight attorneys general, the committee's description highlights the breadth of its role:

The NAAG Charities Committee mission is to assist and enable attorneys general concerning charities registration and enforcement issues and matters by providing information, communication and support; to facilitate cooperation among the various areas of attorneys general offices that handle charities registration and enforcement through open dialogue and communication; to plan, organize and conduct training and annual seminars in coordination with the National Association for State Charities Officials and its assistant attorney general members for the exchange of ideas and information on matters relevant to charities registration and enforcement; and to promote the development of effective charities registration and enforcement programs and education for the protection of citizens and increasing awareness of our duties to our citizens.¹⁵

Ramifications for Nonprofits

So, what do these developments mean for nonprofits? There are several important takeaways:

- **The IRS is not the only sheriff in town.** Especially for charities, state regulators have the authority and willingness to pursue wrongdoing. Like the IRS, they face budget pressures and competing priorities, but state regulators are showing an ability to manage these pressures through both innovation at the individual state level and coordination with other states and federal agencies at the national level. Forums such as NASCO, NAAG's Charities Committee, and the Charities Regulation and Oversight Project will only continue to enhance state regulators' ability to do more with their limited resources and to work together.
- **For compliant nonprofits, increased state innovation and cooperation is (mostly) good news.** A primary goal of the ongoing state efforts is to reduce the regulatory burdens on nonprofits that are in good faith seeking to comply with applicable state laws. For

example, New York's Nonprofit Revitalization Act amended New York's Not-for-Profit Corporation Law to raise revenue thresholds for certain audit requirements and to simplify the classification of nonprofit corporations. The Single Portal Initiative's stated goal is to significantly reduce the administrative burden on nonprofits and professional fundraisers that solicit charitable contributions in multiple states, by providing a single online system for required registration and reporting. At the same time, however, these initiatives often impose additional governance requirements on all or some nonprofits, as exemplified by some of the recent changes to New York law and California's Nonprofit Integrity Act of 2004.

- **For noncompliant nonprofits, there is less room to fly below the radar.** As states update and revise their laws governing nonprofits and the procedures for enforcing those laws, fewer out-of-compliance nonprofits will be able to escape scrutiny. And increased communication between the states means less opportunity for out-of-compliance nonprofits to avoid oversight by simply ending activities in a given state or relocating to a different state. For example, one aspect of the Single Portal Initiative is to bring together IRS Form 990 data with state registration data, making it easier for state regulators to identify nonprofits that are operating in their jurisdictions without having properly registered or reported, as well as to spot fraudulent activity. These developments are good news for the nonprofit sector as a whole—they should reduce bad behavior, such as that highlighted in the FTC/50-State & DC Lawsuit, that damages the sector's reputation. At the same time, however, less sophisticated and less well-resourced nonprofits that, while otherwise acting properly, have been able to ignore at least some state legal requirements with relative impunity, may no longer be able to do so—including with respect to both charitable solicitation and property tax exemption.

The bottom line is that nonprofits need to be aware that even as IRS enforcement of the federal requirements for tax-exempt organizations continues to be battered by limited resources and


congressional criticism, the states have quietly laid the groundwork for more effective individual and collective oversight of nonprofits. That groundwork is starting to bear fruit, as illustrated by the recent multistate lawsuit, the renewed Single Portal Initiative, and the NAAG Charities Committee, as well as the addition of increasing governance obligations to the nonprofit laws of California and New York. Nonprofits, therefore, must be sure to treat compliance with their state legal obligations as seriously as compliance with their federal tax obligations, as well as making sure to keep track of the ongoing state law developments that could impact them in numerous ways.

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