APPENDIX G
TAX COURT EQUITY AUTHORITIES, PRIVATE RELATOR AND VALUATION

Tax Court Equity Authorities

The Discussion Draft proposes investing the U.S. Tax Court with certain equity powers, including the power to rescind transactions, surcharge trustees and order accountings, in order to remedy any detriment to a philanthropic organization resulting from any violation of the substantive rules, and the power to substitute trustees, divest assets, enjoin activities and appoint receivers to ensure that an organization's assets are preserved for philanthropic purposes and that violations of the substantive rules will not occur in the future. The proposal mirrors one made by the Department of the Treasury in 1977,[1] which would have invested such powers in the U.S. district courts.

The Tax Court is a court established under Article I of the Constitution.[2] As such, it has power to adjudicate only those controversies that have been expressly statutorily conferred on it by Congress. The heart of the Tax Court's jurisdiction is the power to redetermine a deficiency asserted by the IRS in income, gift or estate taxes.[3] In certain limited areas, the Tax Court has authority to issue declaratory judgments.[4] Because of the Tax Court's very targeted substantive focus, its judges are generally selected based on their technical expertise in federal tax law. The authority proposed in the Discussion Draft stretches far beyond the Tax Court's core function and expertise of redetermining tax deficiencies. Any such extension would also likely require additional budget and staffing to address the broader substantive scope.

A key consideration is whether the proposed equity powers are necessary tools for enforcing the tax laws. The Tax Court currently has the power to affirm the Internal Revenue Service's denial or revocation of federal tax exemption, to issue declaratory judgments regarding an organization's qualification under Section 501(c)(3) and regarding the qualification of debt obligations as tax-exempt bonds, to affirm the imposition of excise taxes under the private foundation rules and under the intermediate sanctions rules at Section 4958. Indeed, the intermediate sanctions rules, which penalize persons who have substantial influence over a charity and who engage in an excess benefit transaction with the charity, were a legislative response in 1996 to insider abuses, and final regulations under those rules were issued only in 2002. This powerful new tool to combat misdeeds has not yet been given sufficient time to demonstrate its effectiveness.

The Discussion Draft further proposes that the IRS or a director/board member may seek the removal of any director/board member or officer by the Tax Court. It then sets out the standard that the Tax Court would apply in determining whether to remove, as follows: "1) the director or officer engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion with respect to the corporation; or 2) has failed to perform his or her duties in good

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[1] *Treasury Proposals to Improve Private Philanthropy* (Treas. Dept. News Release Jan. 18, 1977), [1977] 9 STANDARD FED TAX REP (CCH) 6156, at 70, 850-57 (Jan. 26, 1977).
[2] *See* Section 7441. Unless otherwise noted, all statutory references in this paper are to the Internal Revenue Code of 1986, as amended.
[3] *See* Section 6213.
[4] *See* Section 6234.

faith; with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and in a manner the director/officer reasonably believes to be in the best interests of the goals and purpose of the corporation." The court could then bar the director or officer from serving on the board, or "any board" for a period established by the court.

This proposal appears to be based on two provisions of the Revised Model Nonprofit Corporation Act (1987) (the "Model Act"). First, Section 8.10 of the Model Act provides that the court of a county where the corporation's principal office is located may, in a suit brought by the corporation, its members, or the attorney general, remove a director if "the director or officer engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion with respect to the corporation," and the court in addition finds that "removal is in the best interests of the corporation." Second, Section 8.30 of the Model Act provides that a director shall discharge his or her duties "(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation." Section 8.42 of the Model Act applies essentially the same standard to officers.

This proposal would provide the Tax Court, a court not generally invested with equity powers, with greater powers to remove officers and directors than those provided to state courts, which commonly exercise equity powers, under the Model Act. A court's removal power arises under the Model Act when a director has committed grievous acts – fraud or dishonest conduct, or gross abuse of authority or discretion with respect to the corporation. Even in this limited circumstance under the Model Act, the court must take the additional step of concluding that removal would be in the best interests of the corporation. The Discussion Draft does not contain such a requirement, and provides an additional, and far broader basis for removal: whenever the director (or officer) has failed to perform his or her duties in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner the director/officer reasonably believes to be in the best interests of the goals and purpose of the corporation. This would empower the Tax Court to remove a director or officer whenever he or she has failed to satisfy an ordinarily prudent person standard of care.

The judicial experience reflected in the common law suggests that it is desirable to consider a wider array of factors in determining whether to take the significant step of removing a director from office, such as whether the director has substantially complied with principles of conflict of interest, whether the governing board consents to any appropriate modifications in governance practices necessary to ensure future compliance, and whether it is reasonable to expect that the director will perform his or her duties as required in the foreseeable future.[5]

A key element in any such decision is the appropriate standard of care to be applied in determining whether a director (or indeed a trustee of a charitable trust, which the proposal does not appear to cover) has fulfilled his or her fiduciary obligations. Every fiduciary of an organization that is qualified as a charity for federal tax purposes will be subject to a standard of care under state law in fulfilling his/her duties, which standard can differ quite

[5] *See, e.g.,* The American Law Institute, Principles of the Law of Nonprofit Organizations, Preliminary Draft No. 2 (May 26, 2004), § 370.

significantly depending on the state's particular formulation of the duty and the type of legal entity involved. States have widely different approaches in their statutory treatment of nonprofit corporations, and may reach different outcomes even under standards of care that are expressed in the same language. The question of the appropriate standard of care for director of a nonprofit corporation has been the subject of a good deal of litigation and scholarly commentary.[6] In states where there is no statutorily mandated standard of care, there is often ambiguity as to whether the trustee standard or the corporate standard should be applied to assess the conduct of directors of nonprofit corporations.

While the Discussion Draft does not specifically address charitable organizations formed as trusts, the trust form is often used, and brings into play a different, and generally higher, standard of care. A common formulation is that a trustee must exercise such care and skill as a person of ordinary prudence would use in dealing with his own property.[7] Some charitable organizations may be formed as unincorporated associations, limited liability companies or even, in limited circumstances, professional corporations, and may be subject to still different state law standards of care.

The Discussion Draft proposal, using as it does one particular state law model formulation of a charitable fiduciary's standard of care, effectively seeks to overlay a federal standard that may differ substantially from the applicable state law standard, and to require the Tax Court to interpret and apply that federal standard. Such a bifurcated scheme would seem to create a great deal of uncertainty for directors, officers and trustees as to what the applicable duty of care may be, and for what actions. It further seems likely to create undesirable inconsistencies between historic state common law and statutory concepts of fiduciary duty and a new, parallel, federal articulation and interpretation of those duties.

Private Action – Directors

The Discussion Draft proposal appears to be based on the Revised Model Nonprofit Corporation Act (1987), Section 6.30, which provides that a director of a nonprofit corporation may bring a derivative suite against the corporation, similar to the rights of shareholders to bring derivative suits under corporate law.

As illustrated by the Model Act on which the proposal is based, directors often have standing to bring an action under state law. States with nonprofit corporation statutes that are based on the Model Act generally provide for such a right of action. States with substantially different statutes may also convey standing to directors, in some cases adding additional safeguards, such as a requirement that the plaintiff notify the attorney general, and the authority of the attorney general to intervene in any such action.[8] In the case of charitable organizations formed as trusts, a co-trustee generally has standing to bring suit to enforce a charitable trust.[9] State courts would also generally have the equity powers proposed above for the U.S. Tax Court,

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[6] *See, e.g., Stern v. Lucy Webb Hayes Nat'l Training School – Deaconesses Missionaries*, 381 F. Supp. 103 (D.D.C. 1974); The American Law Institute, Principles of the Law of Nonprofit Organizations, Preliminary Draft No. 2 (May 26, 2004), § 360.

[7] *See* Restatement (Second) of Trusts, § 174 (1959).

[8] *E.g.,* Cal. Corp. Code § 5142 (West 2004); N.Y. Not-for-Profit Corporation Law § 720 (Consol. 2004).

[9] *See* Restatement (Second) of Trusts, § 391 (1959).

so the proposed avenue for addressing misdeeds involving charitable organizations would seem already to be in place under state law.[10] It is accordingly unclear what additional benefit would be gained by providing a parallel federal right of action.

As a practical matter a state right of action would generally encompass not only the state law applicable to nonprofit corporations but also the federal law concerning tax exemption. In the case of charitable organizations that are classified as private foundations under the federal tax law, many states include in their statutes the private foundation restrictions under Chapter 42 of the Internal Revenue Code.[11] In the case of charitable organizations that are classified as public charities, action (or inaction) by directors that results in an excess benefit transaction under the intermediate sanctions rules or in revocation of federal tax exemption is arguably a per se violation of state law fiduciary obligations. Accordingly, if the goal is to allow a director to bring a derivative suit, e.g., to seek removal of another director for engaging in or approving acts that resulted in violation of the tax law, such an action is likely already available in many, if not most, cases on the basis of asserted violation of state law fiduciary obligations.

Moreover, a federal private right of action to enforce the tax law would represent a significant departure from the current system of enforcement, not only in the context of tax-exempt organizations but in the federal tax law as a whole. Under the current enforcement scheme, IRC Section 7401 prohibits the commencement of any civil action for the recovery of a tax penalty unless the Secretary of the Treasury authorizes or sanctions the proceedings, or the attorney general or his delegate directs that the action be commenced, and precludes the filing of private lawsuits against third parties based upon alleged violations of the Internal Revenue Code.[12] The Discussion Draft does not seem to contemplate any review of the merits of a private action under the tax law by the executive branch prior to the plaintiff filing an action and bringing into play the resources of the federal courts.

Private Relator Action – Individual

The Discussion Draft proposes to permit "any individual" to submit a complaint regarding a charity to the IRS for review. The complaint would be reviewed and evaluated by the IRS. If both the IRS and the appropriate state official decline to pursue the suit, the complainant individual will have the right to bring a suit against the charity. As the Discussion Draft indicates, a few states such as California have given the state attorney general the discretion (but without imposing an obligation) to give relator status to any person to bring an action to enjoin, correct, obtain damages for or otherwise remedy a breach of a charitable trust.[13] In addition, private individuals have been given relator status under Federal law, such as the relator status a person could obtain under the Federal False Claims Act, which was first passed by Congress in 1863 in an attempt to prevent government contractors from bilking the United States during the war between the states. In a qui tam action brought under the False Claims Act,

[10] *See* Revised Model Nonprofit Corporation Act (1987), Section 8.10.
[11] *See, e.g.,* Revised Model Nonprofit Corporation Act (1987) Section 1.50; Wash. Rev. Code § 11.110.210 (2004) (Charitable Trusts).
[12] *See, e.g., Hardin v. Dupont Scandinavia (ARA-JET)*, 731 F. Supp. 1202, 1204 (S.D.N.Y. 1990); *United States Ex Rel. U.S.–Namibia (Southwest Africa) Trade & Cultural Council v. The Africa Fund*, 588 F. Supp. 1350, 1351 (S.D.N.Y. 1984).
[13] Cal. Corp. Code § 5142(a)(5) (West 2004).

a private person is allowed to bring a suit on behalf of the United States. The purpose of these "qui tam" provisions is to encourage private citizens who may know of fraud against the Federal government to come forward. The qui tam provisions encourage private citizen relators, while also restricting their access to the courts through a series of jurisdictional bars.[14]

There are several considerations that should be evaluated during the course of considering whether it is appropriate to grant private relator status to individuals as proposed. First, it is unclear whether an individual would be able to obtain relator status simply because the IRS and the relevant state official decline to pursue the lawsuit. In California, the attorney general has the sole discretion to determine whether to grant relator status and anecdotal experience suggests that the attorney general seldom has done so. Similarly, in the False Claims Act, a qui tam relator is required to file the complaint under seal and, while the proposed qui tam relator can pursue the action if the government chooses not to, the predicate for bringing a qui tam action is fraud, a rather high standard.

Second, the recommendation contemplates a demand must be made by the individual complainant to obtain action by the directors or the complainant must state either why the complainant could not obtain the action or why they did not make the demand in the first place. A similar requirement is found in state corporation laws pertaining to shareholder derivative actions. As an example, in Delaware this requirement is set forth in Chancery Court Rule 23.1, as follows:

> In a derivative action brought by 1 or more shareholders or members to enforce a right of a corporation . . . the complaint shall . . . allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort.

With respect to a demand on directors, Chancery Court Rule 23.1 is virtually identical to its Federal counterpart, Federal Rule of Civil Procedure 23.1. The United States Supreme Court has held that the demand requirement is substantive rather than procedural.[15] The purpose of the demand requirement is "first to ensure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits."[16]

Unlike state and federal shareholder derivative lawsuits, the Discussion Draft proposal contemplates that "any individual" may submit a complaint irrespective of whether that individual is a member of the charity or has any other relationship with the charity. In fact, it appears that the individual need not even be a member of the charitable class directly benefited by the charity. Some level of nexus with either the charity itself or the benefited class should be required as a predicate to a party achieving relator status. An overly-broad grant of relator status could lead to charities incurring substantial costs to defend lawsuits that are ultimately determined to be frivolous, brought by parties with no relationship to the charities and their missions.

[14] *See, e.g., United States v. East Alabama Healthcare Authority*, 953 F. Supp. 1404, 1407 (M.D. Ala. 1996).
[15] *Kamen v. Kemper Financial Services, Inc.*, 500 U.S. 90 (1991).
[16] *Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. 1984).

A good example of the potential consequences of granting open-ended relator status is a lawsuit brought by an individual against 13 charitable foundations located in the Buffalo, New York area alleging racial discrimination against himself, his children and his foundation in that the foundations refused to hire him as a director of their foundations, refused to give scholarships to his children and refused to grant money to his foundation, all for reasons of race. The individual also challenged an alleged pattern of discriminatory employment and investment by the foundations. The individual sought injunctive and declaratory relief, damages, the revocation of the foundations' tax exempt status, and an order directing the foundations to surrender all their assets to the United States Treasury. This action ultimately was dismissed. According to the U.S. district court:

> Time and again the plaintiff has failed or refused to follow the directions of the Court. He has failed to file objections to interrogatories, to file answering affidavits in support of his resistance to the summary judgment motions, and has failed to file the explanatory affidavits required by the orders. He tactics have been designed to frustrate a reasonable resolution of the problems facing the Court and, at times, have bordered on the contemptuous. His refusal to follow the directions of the Court has required the expenditure of a great deal of time and money on the part of the litigants and the Court. Although given every opportunity to make a case and to respond to the motions within the rules, the plaintiff has failed or refused to do so.[17]

It is significant to note that this lawsuit was initially dismissed by the U.S. district court on the pleadings but was reversed in part, affirmed in part and remanded for further proceedings by the Court of Appeals for the Second Circuit.[18] Thus, this represents a good example of a lawsuit found to be completely frivolous yet one that undoubtedly cost the foundations involved tens of thousands if not hundreds of thousands of dollars to defend.

Moreover, because the question of whether a demand has been made is a substantive matter, rather than a procedural matter, it can be expected that this too would be an issue that would be hotly contested by a charity, particularly if the charity believed that the complaint was frivolous or represented a strike suit.

Finally, this type of procedure will require considerable resources to administer at the IRS and the relevant state officials are unlikely to have resources sufficient enough to allow them to stay the suit within the 30 day time period proposed.

Valuation Resolution

The Discussion Draft proposes "baseball arbitration to resolve disputes between taxpayers and the IRS concerning the value of property contributed to a charity." Under baseball arbitration each party to a proceeding submits a number to an independent arbitrator. Following

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[17] *Jackson v. Statler Foundation*, 75-2 U. S. Tax Case (CCH) ¶ 9721 (W.D. N.Y. 1975).
[18] *Jackson v. Statler Foundation*, 496 F.2d 623 (2d Cir. 1974), cert. den. 420 U.S. 927 (1975).

a hearing the arbitrator must select one of the numbers submitted, precluding the arbitrator from "splitting the baby."

There is first an issue as to whether it is desirable as a matter of tax policy to identify one particular valuation issue for special treatment. The determination of value is a pervasive issue throughout the law of taxation. In the exempt organizations area alone, far from being limited to issues involving charitable contributions, the question of value is central in a multitude of situations, such as the value of assets involved in transactions between charities and insiders to determine whether there is private inurement, the value of assets contributed to joint ventures between exempt and non-exempt parties to determine whether there is excess private benefit, and the reasonableness of executive compensation, to name a few. It is equally prevalent in other areas of tax law, such as corporate formation, distributions and reorganizations, allocations of purchase price, transfer pricing, the application of estate and gift tax, partnership formation, compensation, etc. It would seem anomalous and inconsistent to impose a rigid procedure for resolving valuation issues only in the context of charitable contributions when the question of value permeates the tax law generally.

With respect to the particular dispute resolution procedure proposed, there is a great deal of academic literature evaluating the effects of baseball arbitration, including the extent to which it affects the likelihood of settlement, and how the results of such arbitration compare with the potential range of negotiated settlements. California's Commission on Health and Safety and Worker's Compensation commissioned an in-depth study of the literature in the area in 1999.[19] The authors concluded that the evidence in the literature supports the contention that baseball arbitration increases the probability of settlement between parties. They nevertheless expressed significant concern regarding the practical implementation of the procedure, including the tendency of the parties and the arbitrators to seek to avoid its usage. The authors also noted that baseball arbitration tends to favor the party that is less risk-averse, which in the context of a tax controversy will generally be the government, raising concerns regarding the equity of the procedure. A review and understanding of the California experience could provide valuable empirical data in considering a baseball arbitration approach in the tax arena.

Putting those issues aside, the Discussion Draft proposes utilizing baseball arbitration at two stages of dispute resolution: the IRS administrative appeal, and in litigation. At the appeals stage of a valuation controversy, the IRS and the taxpayer would be bound by the parties' respective valuation positions. The IRS appeals officer would then be required to accept one of the two valuation positions. While it seems possible that this approach in the administrative appeals context may encourage settlement, a variation on baseball arbitration, known as "night baseball arbitration" may be more appropriate to counteract concerns with potential perceived bias by appeals officers towards the IRS position. In night baseball arbitration, as in baseball arbitration, each side chooses a number. In night baseball arbitration, however, the numbers are not revealed to the arbitrator. The arbitrator makes a decision regarding the value, selecting his/her own number, and the parties must then accept whichever of their figures is closer to the arbitrator's number.

[19] Frank Neuhauser and Charles Lawrence Wezey, Esq., "Preliminary Evidence in the Implementation of 'Baseball Arbitration' in Workers' Compensation," (Nov. 1999), available at www.dir.ca.chswc/basebalarbffinal.htm.

While baseball arbitration may be a feasible approach with respect to valuation controversies in the administrative appeals context, in the litigation context it raises both policy and constitutional issues. The determination of value is a question of fact. The trial judge (or the jury, if the action is brought in U.S. district court and a jury is requested) is the trier of fact, and brings to bear all his/her knowledge and expertise on what is frequently the key factual issue in a tax case. The jurisdictional provisions of the Internal Revenue Code explicitly recognize the value of this judicial role: the Tax Court has specific authority to issue declaratory judgments concerning the value of gifts for gift tax purposes.[20] To require baseball arbitration on a valuation question would effectively remove judicial discretion in determining the facts of a case.

The recent case of *Caracci v. Commissioner,* 118 T.C. 379 (2002), the first case under the intermediate sanctions provisions at Section 4958, presents a judge's view of the importance of judicial discretion in determining value. The central issue in the case was the value of assets transferred by charitable organizations to corporations controlled by a family that controlled the charities and owned the corporations. Judge Laro, in his opinion, described the role of the judge in determining value as follows:

> As typically occurs in a case of valuation, each party relies primarily upon an expert's testimony and report to support the respective positions on valuation. A trial judge bears a special gatekeeping obligation to ensure that any and all expert testimony is relevant and reliable. [Citations omitted.] The Court has broad discretion to evaluate the cogency of an expert's analysis. [Citations omitted.] Aided by our common sense, we weigh the helpfulness and persuasiveness of an expert's testimony in light of his or her qualifications and with due regard to all other credible evidence in the record. [Citations omitted.] We may embrace or reject an expert's opinion in toto, or we may pick and choose the portions of the opinion to adopt. [Citations omitted.] We are not bound by an expert's opinion and will reject an expert's opinion to the extent that it is contrary to the judgment we form on the basis of our understanding of the record as a whole. [Citations omitted.][21]

A taxpayer has three forum options for bringing an action concerning tax liability. The taxpayer may file a petition in the Tax Court for redetermination of a proposed deficiency, or the taxpayer may pay the tax and file an action for refund in either the Court of Federal Claims or the U.S. district court. The baseball arbitration proposal raises special issues in the context of actions brought in the U.S. district courts, which are established under Article III of the Constitution.

There is a question whether a statute could permissibly require a U.S. district court to choose between two predetermined numbers in making the factual determination of value. The Federal Sentencing Guidelines would seem to present a similar situation – although

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[20] § 7477.
[21] 118 T.C. at 393-4.

there is no obvious policy parallel in the charitable contribution valuation context to the public interest in ensuring that persons convicted of the same crime receives similar sentences. (Baseball arbitration does not even seem to ensure similar results for similar taxpayers, because the procedure is designed to enhance motivation to settle, rather than to establish fair market value.) Indeed, even sentencing guidelines may not pass Constitutional muster.[22]

In addition, both the taxpayer and the government have the right to obtain a jury trial in U.S. district court.[23] The taxpayer's rights in this regard are based in the Seventh Amendment to the Constitution, and it would not seem that they could not be overridden by a statute requiring the court to apply baseball arbitration in the determination of a factual issue.

[22] *See Blakely v. Washington,* No. 02-1632 (U.S. Supreme Court, June 24, 2004), in which the Supreme Court invalidated Washington State's sentencing guidelines as unconstitutional because they allow defendants' sentences to be increased by judges instead of juries.

[23] *See* U.S. Const., Amd. VII; 28 U.S.C. § 2402.