March, 1999

A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance? (symposium)

Evelyn Brody, *Chicago-Kent College of Law*

A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?

Evelyn Brody*

"IRS Is Threatening to Revoke Status of Hawaii Estate if Trustees Don't Quit," blared the headline in the *Wall Street Journal*.[1] I could not believe this brinkmanship by the Internal Revenue Service against the 115-year-old, $6 billion Kamehameha Schools Bishop Estate ("KSBE"). I felt like a witness to the collision between the Irresistible Force and the Immovable Object.

A week later it was essentially over, a higher authority having intervened to prevent catastrophe. On May 7, 1999, probate court judge Kevin Chang accepted the interim resignation of trustee Oswald Stender and ordered the temporary removal of the four other trustees.[2] Judge Chang found credible the IRS's "non-negotiable" threat that unless all five trustees resigned or were removed, the Service[3] would move to revoke the exemption of the Estate. In place of these "Incumbent Trustees," Judge Chang installed the existing five

---

* Associate Professor of Law, Chicago-Kent College of Law; B.A., Yale College, 1976; J.D., Georgetown University Law Center, 1981. This work was supported by the Marshall D. Ewell Research Fund at the Chicago-Kent College of Law. Randall Roth, while he disagrees with some of my conclusions, was unstinting in his willingness to discuss this case with me, and to keep me apprised of the developing facts. I appreciate comments on earlier drafts from Professor Roth, John Colombo, Marion Fremont-Smith, Jack Siegel, Al Slivinski, and participants at the 28th Annual Conference of the Association for Research on Nonprofit Organizations and Voluntary Associations (Washington, D.C., Nov. 6, 1999), and the careful eye of editor Elijah Yip. Although I served as an attorney/advisor in the Office of Tax Policy at the U.S. Treasury Department from 1988-1992, my tenure preceded the development of the intermediate sanctions legislation discussed in this Article, and I have no personal knowledge of Bishop Estate matters; all opinions expressed are mine alone. I regret that as one century-old Hawaiian institution emerges from crisis strengthened and renewed, the equally venerable newspaper *Honolulu Star-Bulletin* announced its shutdown, and remains functioning only as the result of litigation; the *Star-Bulletin*'s coverage of the Bishop Estate kept pressure on the investigation, and I could not have written this piece without the documents and news stories maintained in the paper's online database.

[1] Lee Gomes, *IRS Is Threatening to Revoke Status of Hawaii Estate if Trustees Don't Quit*, WALL. ST. J., Apr. 30, 1999, at A16.

[2] *See* Order Regarding Order to Show Cause Regarding Special Purpose Trustees' Report and Order to Show Cause Regarding New CEO Based Management System, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. May 7, 1999), *available at* <http://starbulletin.com/1999/05/07/news/removal.html> [hereinafter Removal Order].

[3] Throughout this Article, I use the abbreviations "IRS" and "Service" interchangeably.

"Special Purpose Trustees" to act as "Interim Trustees."[4] Judge Chang had previously appointed these individuals to deal with the IRS on KSBE's tax issues, having found that the highly-compensated regular trustees faced insurmountable conflicts of interest due to their own potential tax exposure.[5]

Judge Chang's decisive act is all the more startling in the context of complex and expensive legal wrangling that seemed to be going in circles. Just the day before, another probate court judge *permanently* removed trustee Lokelani Lindsey, upon suit filed December 29, 1997, by co-trustees Oswald Stender and Gerard Jervis.[6] On September 9, 1998, the Hawai'i Attorney General sued for the temporary removal of all five trustees (although she later excluded trustee Stender from her suit[7]), charging that they jeopardized the tax-exempt status of the trust; on September 10, 1998, the Hawai'i Attorney General sued for the permanent removal of trustees Richard Wong, Henry Peters, and Lindsey, charging that they took part in a pattern of self-dealing and mismanagement; on November 25, 1998, Peters was indicted for theft in

---

[4] The five Interim Trustees are Robert Kihune, David Paul Coon, Francis Keala, Constance Lau, and Robert Libkuman. *See* Rick Daysog, *Interim Trustees Make Big Changes*, HONOLULU STAR-BULLETIN, July 9, 1999, at A-1.

[5] Order Granting Trustees Stender and Jervis' Petition for Approval of Voluntary Recusal With Respect to Pending Tax Audit and For Appointment of a Panel of Special Administrators With Respect to Pending Tax Audit Filed January 21, 1999 (filed Feb. 26, 1999), described in Removal Order, *supra* note 2.

Not only was it unprecedented (to my knowledge) for a judge to appoint special-purpose trustees to handle the tax issues while leaving the regular trustees in place, but also one can only speculate about how this arrangement might have played out. What does it mean to have one set of trustees for the "real" issues and another set for the tax issues? Are we to assume not only that the special-purpose trustees kept the regular trustees in the dark about the IRS proceeding, but also that the regular trustees kept the special-purpose trustees in the dark about ongoing KSBE matters? What if these KSBE matters—like investment decisions and compensation issues—could give rise to fresh violations of tax requirements? *See generally* Special Purpose Trustees' Report, Apr. 27, 1999 (describing the Special Purpose Trustees' belief that they lack the authority to meet IRS demands to: (1) remove the incumbent trustees; (2) control or determine the method for selecting new trustees; (3) limit the compensation paid to the trustees in the 1999 fiscal year; and (4) prevent the removal of assets from KSBE and subsidiaries beyond the supervision of the court and the IRS). *Cf.* Rick Daysog, *Judge Orders Bishop Estate: Don't Pay Trustees Until I Say*, HONOLULU STAR-BULLETIN, Apr. 30, 1999, at A-1 (reporting that Judge Chang, after learning that each trustee received more than $1 million in the year ending June 1998 and another $862,000 for the first 10 months of the Estate's 1999 fiscal year, ordered the trustees not to take compensation from the Estate or its for-profit subsidiaries until a hearing has been held).

[6] *See* Rick Daysog, *Trustee Lindsey Removed*, HONOLULU STAR-BULLETIN, May 6, 1999, *available at* <http://starbulletin.com/1999/05/06/news/story1.html>.

[7] *See* Rick Daysog, *Bronster Wants Trustees Out, Except Stender*, HONOLULU STAR-BULLETIN, Nov. 14, 1998, at A-1.

a charged kickback deal involving the Estate; and on April 12, 1999, Wong was indicted for theft, perjury and conspiracy.[8] Finally, just 10 days before Judge Chang's temporary removal of the Incumbent Trustees, the Hawai'i Senate refused to reconfirm Margery Bronster to a second term as attorney general, a vote viewed as motivated at least in part by her role in the Bishop Estate investigation.[9]

Events unfolded relatively briskly following the May 1999 temporary removal of the Incumbent Trustees. One by one, all five unconditionally resigned—the final three in December, on the eve of their trial for permanent removal.[10] On December 1, 1999, Judge Chang approved a Closing Agreement, dated August 24, 1999, entered into by the IRS and the Interim Trustees on behalf of KSBE.[11] This Closing Agreement, which again called for the permanent removal of the Incumbent Trustees, also required, among other items: the reorganization of KSBE around a chief executive officer to carry out the policy decisions of the Board of Trustees; the adoption of an investment policy and a spending policy focused on education; adoption of a conflicts-of-interest policy and adherence to the Probate Court's directive for setting Trustee compensation; a ban on hiring any governmental employee or official until three years after termination of governmental service (or earlier Probate Court approval); the Internet posting of the final Closing Agreement and of KSBE financial statements for the next five years; and a $9 million

---

[8] For a timeline through May 6, 1999, see Appendix A to this issue of the *University of Hawai'i Law Review*. Both Wong's and Peter's indictment were quashed, without prejudice to the prosecution, because of tainted testimony. *See* Rick Daysog, *Judge Throws out Wong Grand Jury Indictments*, HONOLULU STAR-BULLETIN, June 16, 1999, at A-1; Rick Daysog, *State Lets Bishop Trustee Wong and Wife off the Hook for Now*, HONOLULU STAR-BULLETIN, June 30, 1999, at A-3; Rick Daysog, *Judge: Peters Didn't Get a Fair Hearing*, HONOLULU STAR-BULLETIN, July 2, 1999, at A-1. Peters was re-indicted on Aug. 4, 1999. *See* Rick Daysog, *Peters, Stone Indicted Again by Grand Jury*, HONOLULU STAR-BULLETIN, Aug. 5, 1999, at A-8. A judge dismissed this indictment without prejudice in December 1999, and a ruling is expected by February 7, 2000, on Peters' motion to bar the attorney general from seeking reindictment. *See Decision Nears on Motion to Drop Case Against Peters*, HONOLULU STAR-BULLETIN, Jan. 19, 2000, at A-2. On December 10, 1999, Wong was indicted for perjury. Rick Daysog, *Grand Jury Indicts Wong for Perjury*, HONOLULU STAR-BULLETIN, Dec. 10, 1999, at A-1.

[9] *See* Rick Daysog, *Trustees Deny Influence on Senate*, HONOLULU STAR-BULLETIN, Apr. 29, 1999, at A-1.

[10] *See* Leila Fujimori, *Critics See Hope Ahead as Last Trustee Falls*, HONOLULU STAR-BULLETIN, Dec. 17, 1999, at A-4.

[11] The text of Judge Chang's December 1, 1999 "Order Approving Petition for Approval of Settlement of IRS Audit Issues" [hereinafter Order Approving Settlement] is available in LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 238-60, *Hawaiian Court Approves IRS Settlement with Educational Trust* (Dec. 13, 1999).

payment (plus interest).[12] However, the deal does not extend to KSBE's taxable subsidiaries, from which the IRS is reportedly seeking $46 million.[13] Moreover, the Closing Agreement does not cover any personal tax liability of the trustees.[14] As a separate matter, the Attorney General also seeks fines and surcharges from the former trustees for imprudent management and self-dealing; a trial on these issues is scheduled to begin in September 2000.[15]

The Bishop Estate saga arose under a unique set of facts and law practically designed to create fiduciary conflicts of interest.[16] As detailed below, in 1884 Bernice Pauahi Bishop, a descendent of King Kamehameha, devised her vast landed estate to establish a school for Hawaiian children. Her Will directed that successor trustees be named by the individual justices of the Hawai'i Supreme Court. The governor of Hawai'i appoints the justices.[17] Inevitably, the appointment of trustees to Kamehameha Schools Bishop Estate became a political payoff. What made service so desirable? As Hawai'i law developed

---

[12] See Rick Daysog, *Proposed Estate Deal: Pay IRS $9 Million-Plus*, HONOLULU STAR-BULLETIN, Aug. 23, 1999, at A-1. The IRS initially sought $65 million. *See* Stephen G. Greene, *Bishop Estate to Pay IRS $9-Million but Retain Its Tax-Exempt Status*, CHRON. PHILANTHROPY, Dec. 16, 1999, at 32. The Proposed Closing Agreement, dated August 18, 1999, was filed as Appendix II to the Petition for Removal of Trustees Marion Mae Lokelani Lindsey, Henry Haalilio Peters and Richard Sung Hong Wong, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Aug. 24, 1999), and is posted on KSBE's website at <http://www.ksbe.edu/news&info/filings/final.pdf> [hereinafter Closing Agreement].

[13] This $46 million expected settlement amount is less than a third of the $165 million tax bill originally feared—and negotiations could bring the amount down even further. *See* Rick Daysog, *Estate's Tax Bill Shrinks to $46 Million*, HONOLULU STAR-BULLETIN, Feb. 8, 2000, at A-1. *Cf.* Stephen G. Greene, *Kamehameha Schools Faces $165-Million Tax Bill*, CHRON. PHILANTHROPY, Jan. 13, 2000, at 50; Rick Daysog, *Bishop Board Focusing on Education Programs, Investments*, HONOLULU STAR-BULLETIN, Dec. 21, 1999, at A-2.

[14] *See* Closing Agreement, *supra* note 12, at 9 (regarding trustees), 29 (regarding non-exempt affiliates).

[15] See Rick Daysog, *'End of the line'*, HONOLULU STAR-BULLETIN, Dec. 17, 1999, at A-1 ("[Deputy Attorney General] Morris said the state will continue to press its surcharge claims against [the] trustees for causing tens of millions of dollars of damage to the estate. Trial is scheduled for next September.")

[16] *See* Edward Halbach, *Foreword*, 21 U. HAW. L. REV. i (1999); James R. McCall, *Endangering Individual Autonomy in Choice of Lawyers and Trustees—Misconceived Conflict of Interest Claims in the Kamehameha Schools Bishop Estate Litigation*, 21 U. HAW. L. REV. 487 (1999); Randall W. Roth, *Understanding the Attorney-Client and Trustee-Beneficiary Relationships in the Kamehameha Schools Bishop Estate Litigation: A Reply to Professor McCall*, 21 U. HAW. L. REV. 511 (1999); James R. McCall, *Comment on Professor Roth's Reply*, 21 U. HAW. L. REV. 531 (1999). *See generally* Samuel King, Msgr. Charles Kekumano, Walter Heen, Gladys Brandt & Randall Roth, *Broken Trust*, HONOLULU STAR-BULLETIN, Aug. 9, 1997, at B-1 [hereinafter *Broken Trust*], reprinted in Appendix C to this issue.

[17] *See Broken Trust*, *supra* note 16.

in the twentieth century, charity trustees became entitled to fees based on charity income. Moreover, huge jumps in renewal rates on long-term land leases prompted legislative reform; forced to sell residential leasehold lands,[18] KSBE wound up with an estimated $2 billion to reinvest.[19] In the last few years, annual fees for the five Trustees approached and then exceeded $1 million—each.[20] Finally, the Trustees never adopted a corporate-style governance structure to provide management checks and balances; the Trustees retained all administrative authority (not to mention the compensation) rather than create separate officers and limiting their own role to policy matters. By all accounts, the Incumbent Trustees (or at least the majority) were an absolute disaster for KSBE. By contrast, the reforms already instituted by the Interim Trustees,[21] and new court procedures for selecting replacement trustees,[22] promise a happy ending to this long, sad story.

The permanent resignation of the Incumbent Trustees removed the IRS's precondition to entering into the Closing Agreement. Thus, we will never reach an adjudication of the IRS's authority to condition KSBE's tax exemption on replacing the board of trustees. The issue of the extent of federal power, though, is critical to the administration of the charitable sector. Accordingly, I am inspired by this century-old charity—established by a Hawaiian princess and comprising "a feudal empire so vast that it could never be assembled in the modern world"[23]—to invent the court opinions that *might have* been written. What if events had taken an unlikely turn? What if the Incumbent Trustees had refused to resign and the Hawai'i courts delayed in

---

[18] *See infra* note 52.

[19] *See infra* note 55 and accompanying text.

[20] *See* Daysog, *supra* note 5.

[21] *See, e.g.*, Daysog, *Bishop Board to Focus on Education, Investments*, *supra* note 13 (describing new board's plan to restore outreach programs and open a new 300-acre, K-12 campus on the Big Island; adopt a more diversified and stable investment policy; and name a new chief executive officer); *see also* Kamehameha Schools, *Spending and Investment Policy* (Jan. 20, 2000), *available at* <www.ksbe.edu/news&info/spend_invest/index.htm>.

[22] Ken Kobayashi, *Seven-Member Committee Named to Select Trustees*, HONOLULU ADVERTISER, Jan. 7, 2000, at A-1 (describing order of Judge Chang naming an 8-member committee to nominate future trustees for selection by a probate judge, but recognizing that the Hawai'i Supreme Court could resume its practice of naming trustees if it wishes to). The court is considering a recommendation that pay for trustees be capped at $97,000 each ($120,000 for the chair). *See* Rick Daysog, *'There's Still a Lot of Work to Do' in Overhaul of Bishop Estate*, HONOLULU STAR-BULLETIN, Dec. 17, 1999, at A-4.

[23] Todd S. Purdum, *Hawaiians Angrily Turn on a Fabled Empire*, N.Y. TIMES, Oct. 14, 1997, at A1.

ruling on the removal motion, thus prompting the unappeased IRS to made good on its threat to revoke the Estate's federal tax exemption?

According to the Closing Agreement between the IRS and KSBE, KSBE faced possible loss of exemption on two grounds:[24] "private inurement" of charitable assets to the benefit of charity insiders, and operation of KSBE for a private, as opposed to public, purpose.[25] The fictitious opinions set out below consider the high pay enjoyed by the Incumbent Trustees, and whether this results in enough private inurement to threaten the Estate's exemption. I include here the allegation that the Trustees managed KSBE's assets and income in a way that minimized education expenditures and increased the base that determines the Trustees' fees.[26] Separately, my opinions also consider whether for federal tax purposes KSBE fails to conduct a charitable program "commensurate in scope" with its financial resources, so that revocation of exemption is appropriate.[27]

---

[24] The document also describes "a pattern of campaign intervention throughout the years examined by the IRS involving both Federal and state candidates for public office, including incumbents. . . ." Closing Agreement, *supra* note 12, at 3. As described in the first concurring opinion below, Internal Revenue Code section 501(c)(3) conditions charity exemption on abstinence from electioneering, but the IRS appears to administer this absolute requirement by applying a de minimis standard. The $9 million payment called for by the Closing Agreement "includes an excise tax under IRC Section 4955 for political intervention during the taxable years 1992 through 1996." *Id.* at 27.

[25] *See* Letter from Miller & Chevalier to KSBE Interim Trustees, "Assessment of Risks of Litigating Revocation Issues," attached as an Exhibit to Petition for Approval of Settlement of IRS Audit Issues (Aug. 24, 1999) [hereinafter Miller & Chevalier Letter], at 4 (describing the draft IRS Notice of Proposed Adjustment labeled "Primary Purpose" as charging that "the educational purpose of the Estate was 'relegated to a position of relative unimportance in the overall operation of the Estate and to a position of relative unimportance to the Trustees.'"). Specifically, the IRS charges that the Incumbent Trustees' "'time, efforts, energy, and financial resources' were 'disproportionately devoted to' investments and commercial activities," and "that the Incumbent Trustees failed to spend enough on education programs: although asset values and revenues increased substantially over the audit period, expenses for 'school operating costs' did not grow 'proportionately,' and the school operated on a 'zero growth budget.'" *Id.*

[26] Perhaps unfairly to the IRS's case, I largely ignore additional private inurement arising from the self-dealing and other financial benefits from the complex web of KSBE intercompany transactions. While the draft IRS Forms 5701, Notices of Proposed Adjustment, are not public documents, Appendix B to the Miller & Chevalier Letter, *supra* note 25, summarizes some of the specific allegations of private inurement, such as KSBE payment of personal expenses and contracts between KSBE and associates and family members of trustees. Sad to say, but the dollar amounts of these transactions, while significant, pale beside the size of the commissions the trustees took. However, these other transactions do lend color to the IRS's assertion of pervasive self-dealing.

[27] In addition, several of the Incumbent Trustees charged that the Service was seriously considering challenging KSBE's admission policy favoring native Hawaiians. *See, e.g.*, Rick Daysog, *Peters: IRS Looks at School Policy*, HONOLULU STAR-BULLETIN, Jan. 29, 1999, at A-1;

While the resolution is close, my fictitious majority opinion rejects both charges, and upholds the Estate's federal tax exemption—at least at this stage in the process. Let me make clear that I would not have disagreed with a Probate Court decision to oust any Incumbent Trustees that refused to resign—assuming the judge's decision is made on the individual merits—and to adopt other reforms in KSBE's governance and management structure. Indeed, I believe that Congress generally intended that investigations of charity fiduciary behavior be a state, not a federal, case. I am skeptical of the Service's statutory authority to demand, during the pendency of vigorous state proceedings, that the Incumbent Trustees resign as a quid-pro-quo for not revoking exemption. Moreover, I question the wisdom of doing so.

As a statutory matter, the Service lacks plenary equity powers over charity fiduciaries. As a practical matter, however, revocation of exemption was never the IRS's only weapon. This very case illustrates how the agency has used the *threat* of the ultimate sanction of revocation to exact specific management changes in the course of negotiating "closing agreements" that ensure future compliance—changes including reduced compensation, repayment of amounts improperly obtained or expended, and the adoption of a compensation committee structure or other governance changes. But when the IRS demands that charity trustees or directors resign before negotiating a closing agreement, and the fiduciaries refuse, fiduciary recalcitrance can be ascribed to either of two opposite motives. On the one hand, the fiduciaries might not care about the tax fate of the organization—and if they have been looting the assets in the first place, why should threatened revocation cause

---

see generally Bob Jones Univ. v. United States, 461 U.S. 574 (1983)(upholding the IRS's interpretation of the term "charitable" in Internal Revenue Code section 501(c)(3) as prohibiting tax-exempt private schools from discriminating on the basis of race, a practice which violates fundamental public policy). In the spring of 1999, however, the IRS reaffirmed its 1975 ruling that the Kamehameha Schools' admissions policy is not impermissible race-based. Tech. Adv. Memo. (unnumbered and undated, but referencing a conference date of Feb. 4, 1999), filed as Exhibit B to Kamehameha Schools Bishop Estate, Supplemental Appendix to Form 1023, Reaffirmation Submission (Aug. 18, 1999)(finding that, while all students have some quantum of Hawaiian ancestry, many races are represented; moreover, there appear to be federal and state public policies favoring a preference for native Hawaiians); *cf.* Gen. Couns. Mem. 36,363 (1975)(stating, evidently concerning KSBE, that: "technically these facts illustrate discrimination on the basis of national origin" rather than on the basis of race, and suggesting as a possible alternative basis for its ruling the argument that affirmative actions plans might be consistent with anti-discrimination policy). *See generally* Jon M. Van Dyke, *The Kamehameha Schools/Bishop Estate and the Constitution*, 17 U. HAW. L. REV. 413 (1995). However, the 1999 TAM, *supra*, concludes with a suggestion that KSBE consider filing a new private letter ruling request after the Supreme Court issues its opinion in *Rice v. Cayetano*, argued on October 6, 1999.

a change of heart? Alternatively, the fiduciaries might care very much about the organization, and genuinely believe that their continued service is in the best interests of the charity and its beneficiaries. The IRS evidently believed that the first description applied to KSBE, and Judge Chang, aware of the other state court proceedings, evidently agreed with this interpretation. But then if the state court process worked here, why should the IRS not be content to let these proceedings take their course?[28] After all, a state process will still be required to appoint new fiduciaries, if the charity is to be saved. Moreover, by staying its hand, the IRS avoids imposing requirements inconsistent with later state-ordered reforms.[29]

Most important, since 1996 revocation has not even been the IRS's only statutory weapon. That year Congress finally granted the Service "intermediate sanctions" authority to sue charity insiders in cases of private inurement. By requiring that wrongdoers repay "excess benefits" to the charity, new Internal Revenue Code ("Code") section 4958 allows the Service to punish the responsible individuals without necessarily jeopardizing the exemption of the charity. Thus, the federal regime converges with the state law aim of making the charity whole in cases of insider financial benefit.

---

[28] The Interim Trustees' Petition for Removal of Trustees Marion Mae Lokelani Lindsey, Henry Haalilio Peters and Richard Sung Hong Wong, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Aug. 24, 1999) [hereinafter Petition for Removal of Trustees], suggests the potential for IRS bootstrapping by citing trustees' obligations under state law not to deprive the trust of an available tax exemption: "By their refusal to resign, the Remaining Incumbent Trustees have created a significant risk to the Trust Estate's tax exempt status, have breached their duties to their beneficiaries, have violated H.R.S. § 554A-3, and should be permanently removed." *Id.* at 23, *available at* <http://www.ksbe.edu/news&info/filings/removal.pdf>. The Foreword to the Interim Trustees' newly-adopted detailed Governance Policy declares that "if for any reason a Trustee cannot fulfill or has violated his/her fiduciary duties and obligations, he or she, without hesitation, must voluntarily and loyally resign as a Trustee." Kamehameha Schools Bernice Pauahi Bishop Estate, *Governance Policy* (Aug. 18, 1999), *available at* <http://www.ksbe.edu/news&info/filings/govern_doc.pdf>. KSBE's exemption-application supplemental filing, dated August 18, 1999, enumerates 28 grounds for removal of a trustee for cause under state law. *See* Kamehameha Schools Bishop Estate, Supplemental Appendix to Form 1023, Reaffirmation Submission (Aug. 18, 1999), *available at* <http://www.ksbe.edu/news&info/filings/FinalReaffirmDoc.pdf> [hereinafter Exemption-Application Supplemental Filing].

[29] Notably, in describing the benefits of an exempt organization's waiving confidentially protections and thereby permitting the IRS to cooperate with a State investigation, IRS Exempt Organizations Director Marcus Owens stated: "That enables the IRS and state attorneys general to make sure that both regulatory agencies, which have virtually congruent interests, are satisfied that the changes made are appropriate and that you're not going to have 15 changes coming down from the IRS conflicting with directives from the state attorney general." Fred Stokeld, at al., *With Changes Afoot, EO Reps Get the Latest from IRS, Treasury*, 85 TAX NOTES 1136, 1137 (Nov. 29, 1999).

Indeed, the Service long petitioned Congress for such an intermediate remedy precisely to avoid compounding the harm to the innocent beneficiaries of charity. Significantly, the legislative history to this new Code section 4958 declares Congress's intent that intermediate sanctions should be the *only* remedy where the continued operations of the charity are not inconsistent with tax exemption.[30] Assuming further and imminent significant reform of KSBE's management and operations, I have trouble seeing a court upholding the revocation of KSBE's exemption, given that it is operating a genuine charitable program.

No intermediate sanctions laws, unfortunately, apply to fiduciaries of "public charities" who breach duties other than of financial loyalty. Thus, for such inadequacies of governance as running an indifferent charitable program, accumulating excess income, or paying undue attention to investment returns, the IRS is as helpless (or powerful) now as it was before new Code section 4958. By contrast, for those charities designated as "private foundations," Congress in 1969 adopted a panoply of intermediate sanctions. As an educational institution, KSBE automatically qualifies as a public charity, although its enormous endowment would otherwise cause it to be classified as a private foundation. Paradoxically, then, the only statutory remedy available to the IRS for KSBE mismanagement not involving private inurement remains revocation of exemption. Hawai'i's recent statutory limit of "reasonableness" on charity trustee fees has removed any personal incentive for trustees to accumulate KSBE income for investment, and courts generally refrain from micro-managing charities. Accordingly, I do not see revocation as an appropriate sanction for perceived deficiencies in KSBE's investment and spending activities.

In the sound administration of nonprofit governance, the Internal Revenue Service is an important and helpful player. My institutional concern being for the Service, I cannot believe that an IRS that usurps state law is good for either the IRS, the states, or the charitable sector. Worse, few charities, small or large, can afford such a high-stakes gamble by challenging the IRS over their very claims to exemption: Until the case is resolved in court, donations could dry up, tax-exempt bond covenants could be breached, and local governments might challenge property-tax exemption. Yet should the issue addressed in this Article never reach the courts, the IRS might increasingly

---

[30] *See* H.R. REP. No. 104-506, at 59 n.15 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143, 1182 n.15.

threaten to pull charities' exemptions, a heavy-handed approach besmirching the Service's bona fides in the administration of exempt-organization cases.

Better would be for Congress to permit the IRS to share investigative information with the State attorneys general for their own investigations, as recommended by a January 2000 study by the staff of the Joint Committee on Taxation.[31] Under current law, the states may share information with the IRS, but the IRS may inform nontax state regulators only of the denial or revocation of tax-exempt status.[32] Worse, it does not appear that the IRS could inform state authorities when it imposes intermediate sanctions on charity insiders (because this would not be a final determination with respect to the organization);[33] this might put pressure on the IRS also to revoke

---

[31] JOINT COMM. ON TAX'N, STUDY OF PRESENT-LAW TAXPAYER CONFIDENTIALITY AND DISCLOSURE PROVISIONS AS REQUIRED BY SECTION 3802 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998, VOLUME II: STUDY OF DISCLOSURE PROVISIONS RELATING TO TAX-EXEMPT ORGANIZATIONS 101-05 (JCS-1-00, Jan. 28, 2000), *available at* <http://www.house.gov/jct/s-1-00vol2.pdf>. Specifically—

> The Joint Committee staff recommends that the IRS should be permitted to disclose to Attorneys General and other nontax State officials or agencies audit and examination information concerning tax-exempt organizations with respect to whom the State officials have jurisdiction and have made a specific referral of such organization to the IRS prior to a final determination with respect to the denial or revocation of tax exemption. In addition, the Joint Committee staff recommends that the IRS should be permitted to share audit and examination information concerning tax-exempt organizations with nontax State officials and agencies with jurisdiction over the activities of such organizations and who regularly share information with the IRS when the IRS determines that such disclosure may facilitate the resolution of cases.

Id. at 101. The report concludes: "In order to ensure that the information provided to State officials is used for appropriate purposes, the Joint Committee staff recommends that additional information provided to such officials should be subject to the confidentiality and nondisclosure restrictions applicable to State officials under section 6103." *Id.* at 105. The initial public reaction to this proposal has been favorable, although other aspects of the Joint Committee's report are proving controversial (notably its recommendation regarding closing agreements, discussed in note 119, below). *See, e.g.*, Carolyn Wright & Fred Stokeld, *EO Practitioners, Former Officials React to JCT Disclosure Study*, 86 TAX NOTES 744 (Feb. 7, 2000).

[32] *See* Treas. Reg. § 301.6104(c)-1.

[33] The Treasury Regulations, which predate the enactment of section 4958, contemplate either the revocation of the organization's exemption or a penalty tax imposed on the organization itself. *See* Treas. Reg. § 301.6104(c)-1(c).

exemption just so that the state may become informed.[34] Accordingly, the study observes:

> because a final determination by the IRS concerning the denial or revocation of tax-exempt status may not be made for a number of years, a tax-exempt organization may have exhausted its assets through illicit transactions or disposed of its assets or changed its operations in a way which can no longer be corrected by the time the IRS is permitted to provide notice to the appropriate State officials.[35]

Appearing on a recent panel discussing the relationship between state charity regulators and the IRS, former Hawai'i attorney general Bronster eloquently described her frustration at not knowing whether she was duplicating the efforts of the IRS in her Bishop Estate investigation; her belief that the Incumbent Trustees were providing conflicting information to her office and to the IRS; and her desire to obtain documents being denied her by the Incumbent Trustees (who initially claimed confidentiality under the tax laws!).[36]

The development of nonprofit law will be as much affected by what happens to the Incumbent Trustees as by what happens to the Bishop Estate. Regrettably, because of lack of publicly available facts, my opinions below do not include the individual trustees and their likely significant tax problems. I do believe, though, that the most likely outcome of the IRS investigation will be intermediate sanctions imposed on the Incumbent Trustees. If the IRS cannot prove that the Incumbent Trustees' compensation was "unreasonable," it is hard to conceive of a situation in which this new regime would apply. However, because of the relatively recent effective date of this statute, its uncertain scope, and the potentially enormous sums involved, a settlement will

---

[34] The Joint Committee on Taxation's disclosure study quotes a 1975 comment by then-IRS Assistant Commissioner (EP/EO) Alvin D. Lurie:

> Either we can determine not to revoke the exemption, thereby presumably being unable to inform the state attorney general about a situation calling for his action; or, in some cases no less unacceptably, we can compound an already difficult situation by revoking the exemption and imposing ordinary income taxes against the charitable assets, and giving notice of this action to the state attorney general.

JOINT COMM. ON TAX'N, *supra* note 31, at 103.

[35] *Id.* at 103 (citing James B. Lyon, *The Supervision of Charities in the United States by the State Attorneys General (and Other State Agencies) and the Internal Revenue Service*, N.Y.U. 24TH CONF. ON TAX PLANNING FOR 501(C)(3) ORGANIZATIONS, § 5.04 (1996)).

[36] *See Author's Notes of the January 21, 2000 ABA Exempt Organizations Committee Meeting* (forthcoming April 2000) [hereinafter *EO Committee Meeting*] (panel on "When the Left Hand is Required to Leave the Right Hand in the Dark: The Monodirectional Interface Between IRS Auditors and State Attorneys General," with panelists Margery S. Bronster, former Hawai'i attorney general; Richard Allen, former Massachusetts attorney general; and Marcus Owens, director of IRS Exempt Organizations Division).

be probably be reached. (I confess to some surprise at the willingness of the Incumbent Trustees to resign without a simultaneous determination of their potential state and well as federal personal exposure: Evidently they calculated that they were demonstrating sufficient good faith to forestall maximum financial sanctions.)

Let me now introduce the fictitious court opinions that follow. Readers will immediately notice unusual stylistic features. First, while the "facts" are based to the extent possible on court-filed documents that have been made public, I also rely on news stories. (I apologize to those privy to the actual facts for any unintentional inaccuracies.) Second, because I write for a general audience, I explain and footnote somewhat more than would an actual judge (but, for convenience, I number the notes sequentially). On the other hand, I adopt three major, and unrealistic, simplifications: A real adjudication of this case would cover the KSBE affiliates included in the audit; revocation would likely be retroactive to the beginning of the audit (1992); and decision would be entered only after a (lengthy) trial.[37] Finally, because the legal issue is so close, I chose to bring this declaratory judgment action in the United States Tax Court, where the trial judge's opinion could be reviewed by the full court, and I supply two concurrences and one dissent. However, not daring to predict anyone's views, I invent my own Tax Court judges.[38]

---

[37] First, the Closing Agreement, *supra* note 12, includes the tax-exempt Kamehameha Activities Association, both on its own and as successor to Pauahi Holdings Corporation, Inc. *See id.* at 1. Second, the Closing Agreement describes the draft IRS Forms 5701, Notice of Proposed Adjustments, issued on January 4, 1999 to KSBE as proposing to revoke exemption retroactive to July 1, 1989. *See id.* at 3. The Miller & Chevalier Letter, *supra* note 25, quantifies the substantial cost of retroactive loss of exemption: "We understand that the anticipated size of the tax payment could be in excess of $500 million (excluding interest) for the Estate's 1992 to 1998 tax years. . . ." *Id.* at 17. Third, this letter concludes: "It is our view that the Service's proposed revocation would raise material issues of fact that would be disputed by the parties[, and so] a lengthy trial would be required" in which "[t]he burden of proof would be on KSBE to introduce credible factual evidence establishing that it is entitled to retain its section 501(c)(3) status." *Id.* at 18.

[38] Among other stylistic deviations, I commonly refer to the parties as Kamehameha Schools/Bishop Estate ("KSBE") and the Internal Revenue Service ("IRS" or "Service") rather than exclusively as "petitioner" and "respondent." Incidentally, in a move to shed some of the bad associations the public makes with the name "Bishop Estate," the Interim Trustees adopted a resolution, effective January 1, 2000, to shorten the name of the institution to "Kamehameha Schools." Communications will include the following acknowledgement: "Founded and Endowed by the Legacy of Princess Bernice Pauahi Bishop." *See* <www.ksbe.edu/news&info/announcements/name_change.pdf>.

BERNICE PAUAHI BISHOP ESTATE AND TRUST,
Petitioner

v.

INTERNAL REVENUE SERVICE,
Respondent

Tax Court Docket No. 1234-2000 X
Filed Dec. 1, 2000

GIRARD, J.

OPINION

This case is before us on petitioner's motion for summary judgment pursuant to Rule 121.[39] Petitioner initiated this action following a decision of respondent to revoke its tax-exempt status. Petitioner seeks a declaratory judgment under section 7428[40] that it continues to qualify as an organization described in section 501(c)(3) which is exempt from tax under section 501(a) and that it continues to qualify as an organization described in section 170(c)(2). The parties have stipulated to all relevant facts. In this case of first impression, we must decide how, if at all, new section 4958, enacted in 1996, affects the prohibition under section 501(c)(3) against private inurement. We are also asked to determine whether the petitioner should lose its exemption on the ground that it fails to carry on a charitable program commensurate in scope with its financial resources. Upon consideration of the motion, the Court concludes that the petitioner has established that there are no material facts in dispute and that it is entitled to judgment as a matter of law.

I. FACTUAL BACKGROUND

A. History of KSBE Operations

Petitioner, the Bernice Pauahi Bishop Estate and Trust, is a charitable trust whose legal address is 567 South King Street, Suite 310, Honolulu, Hawaii, 96813.

---

[39] Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure.

[40] Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1954, as amended, or the Internal Revenue Code of 1986, as amended, depending on the time period referred to.

Princess Bernice Pauahi Bishop ("Princess Pauahi") was a great-granddaughter and last direct descendant of King Kamehameha I, who unified the Hawaiian islands. Having married New York banker and businessman Charles Bishop against her family's wishes, and having turned down the chance to be queen, the childless Princess Pauahi died testate in 1884.[41] Her landed estate comprised over 375,000 acres (worth approximately $300,000 and producing income of about $30,000 annually) and $18,000 cash.[42] Princess Pauahi left the bulk of her estate for the construction and maintenance of two schools, one for boys and one for girls. (The schools were subsequently combined, and the Estate and schools are often referred to in combination as "Kamehameha Schools Bishop Estate," or simply "KSBE," a term we will use when appropriate.) Over the years, having graduated leaders in all fields of endeavor, KSBE became a "major player on the economic stage of Hawai'i," with "so dominating a presence that critics ascribe to it whatever economic ills may be afflicting the State at any given point in time."[43]

Paragraph 13 of Princess Pauahi's Will directs, in relevant part:[44]

> I give, devise and bequeath all of the rest, residue and remainder of my estate . . . to hold upon the following trusts, namely: to erect and maintain in the Hawaiian Islands . . . the Kamehameha Schools. . . . I direct my trustees to invest the remainder of my estate in such manner as they may think best, and to expend the annual income in the maintenance of said schools; . . . and to devote a portion of each year's income to the support and education of orphans, and others in indigent circumstances, giving the preference to Hawaiians of pure or part aboriginal blood; the proportion in which said annual income is to be divided among the various objects above mentioned to be determined solely by my said trustees they to have full discretion. . . . For the purposes aforesaid I grant unto my said trustees full power to lease or sell any portion of my real estate, and to reinvest the proceeds and the balance of my estate in real estate, or in such other manner as to my said trustees may seem best. . . .

The Will further directs that the individual justices of the Hawaii high court are to name KSBE's successor trustees. This arrangement continued until December 1997, when four of the five justices of the Hawaii Supreme Court announced in a joint statement that "continuing to exercise the powers of appointments granted by the Princess will further promote a climate of distrust and cynicism and, more particularly, will undermine the trust that people must have in the judiciary"; in January 2000, the probate court assumed the power to name new trustees, subject to the authority of the Supreme Court to reclaim

---

[41] *See* Purdum, *supra* note 23.

[42] *See* "The Will of Pauahi and the Will of Her People," Part One: Historical Perspective (1997, 1998), *available at* <http://www.napua. com/html/bonding_part_one.htm>.

[43] *Id.* at <http://www.napua.com/html/bonding_part_one.htm> ("The Legacy").

[44] The Will and Codicil 1 are reprinted in Appendix B of this issue.

it.[45] Furthermore, in recent years the Trustees employed a "lead trustee" system of governance, under which each of the five retained primary responsibility for a specified area of KSBE operations; the Trustees did not even begin to adopt a corporate-style separate executive structure until ordered to do so by the probate court in 1999.[46]

KSBE was a fairly simple organization for its first eight decades. Then the recent land reform described below forced KSBE to sell some of its residential leasehold lands. Because of how the Trustees decided to reinvest the enormous amount of cash generated by these sales, KSBE became much more complicated, in terms of both investment strategy and operations.[47]

KSBE's property—both charitable and investment—is estimated to be worth about $6 billion.[48] The Kamehameha Schools facility is located on a 600-acre campus, and elementary schools at four other locations are either operating or planned.[49] In recent years, KSBE has reported total revenue in

---

[45] Stephen G. Greene, *Trustees of Hawaii's Wealthiest Charity Make Changes to Quell Criticism*, CHRON. PHILANTHROPY, Jan. 15, 1998, at 39. Unfortunately, this leaves the fifth justice apparently in control of appointments. Subject to the justices reclaiming their authority to name Bishop Estate trustees, under a procedure announced by Judge Chang, new trustees will be selected by the probate court from a slate chosen by a committee he appointed in January 2000. *See* Kobayashi, *supra* note 22.

[46] *See* Removal Order, *supra* note 2 (citing, in his temporary removal order, the Incumbent Trustees' failure to obey Judge Chang's earlier order to appoint a chief executive); Daysog, *supra* note 4 (reporting that the Interim Trustees have appointed general counsel Nathan Aipa as KSBE's acting chief operating officer as "part of a larger shift toward a single-voice management system headed by a chief executive officer").

[47] *See* Arthur Andersen LLP, Management Audit Findings, Executive Summary (1998), prepared under the authorization and direction of the Special Master (and agreed to by KSBE) [hereinafter Andersen Report], Executive Summary, *available at* <http://www.napua.com/html/arthurexec.htm>.

[48] *See* Rick Daysog, *Kamehameha's Revenues Surge*, HONOLULU STAR-BULLETIN, Feb. 9, 2000, at A-1 (summarizing audited financial statements recently filed in probate court). *Cf.* Petition of the Attorney General on Behalf of Trust Beneficiaries to Remove and Surcharge Trustees, for Accounting, and for Other Equitable Relief, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Sept. 10, 1998) [hereinafter Petition for Removal and Surcharge], *available at* <http://starbulletin.com/98/09/11/news/removal.html> (Count 5, "The Trustees Have Mismanaged the Trust Assets," second paragraph)(estimating a value as high as $10 billion).

[49] These data come from KSBE's website at <http://www.ksbe.edu/campus/schools.html>. Kamehameha Schools educate 3,200 elementary and high school students. *See* Greene, *supra* note 45, at 39. In 1998, KSBE received a grant of over $1 million from the U.S. Department of Education under the Native Hawaiian Higher Education Program "to continue its eight year administration of various programs and build on its established record of success and innovation program design." Senator Dan Inouye, "Inouye Announces $2,695,229 in United States Department of Education Grants for Native Hawaiian Higher Education Programs," Cong. Press Release, Apr. 29, 1998, available in LEXIS, News Library. *See also* Daysog, *supra* note 4 ("Last month, the new board agreed to install a parent-infant education program, establish new

excess of expenses of almost $187 million (out of revenue of $304 million) in fiscal year 1994, $120 million (out of revenue of $258 million) in fiscal year 1995, and $66 million (out of revenue of $203 million) in fiscal year 1996.[50]

Since Princess Pauahi's Will admonishes the trustees to sell the land only as a last resort, significant portions of KSBE's land were held for long-term lease.[51] In 1967, after years of debate, the Hawaii legislature was finally spurred by the prospect of surging renewal rates to enact reform that eventually forced KSBE to offer its residential land for sale to homeowner/lessees.[52] For the next 17 years, the Estate challenged the constitutionality of this legislation, up through the U.S. Supreme Court, and continues to contest the prices at which it must sell, believing that "forcing a private landowner to sell property only to deliver it into the hands of another private homeowner amounts to theft, as does using government law as a tool to force lower prices."[53] KSBE obtained numerous rulings from the Internal Revenue

---

partnerships with the state Department of Education and add preschool programs for 3-year-old children to the current programs for 4-year-olds.").

[50] Andersen Report, *supra* note 47, at 273.

[51] Will of Princess Pauahi, *supra* note 44, at Codicil 1, para. 17 ("I further direct that my said trustees shall not sell any real estate, cattle ranches, or other property, but to continue and manage the same, unless in their opinion a sale may be necessary for the establishment or maintenance of said schools, or for the best interest of my estate."). Hawaiian land took on a particular significance in the context of its dispossession. *See* GEORGE COOPER & GAVAN DAWS, LAND AND POWER IN HAWAII 413 (1985). "Particularly in Bishop's case, where the trust was perpetual and the beneficiaries were native Hawaiians who over the years had lost so much land, trustees could reasonably believe the estate ought to preserve its lands intact." *Id. Cf.* MATSUO TAKABUKI, AN UNLIKELY REVOLUTIONARY 213 (1998)(Appendix D, "Bishop Estate Today—The Rest of You Tomorrow," July 17, 1984, Rotary Club of Honolulu):

> Had Lunalilo [Estate] directed its trustees, as Princess Pauahi Bishop did, to retain the land and sell it only as necessary to run the home for the aged, the Lunalilo Trust today would rival the Bishop Estate in its net asset value, and it would be able to assist many more than the approximately fifty elderly Hawaiians who now live in Lunalilo Home.

[52] *See* Hawaii Housing Auth. v. Midkiff, 467 U.S. 229 (1984)(upholding Hawaii's Land Reform Act of 1967 as constitutional on public use grounds); *see also* Richardson v. City and County of Honolulu, 124 F.3d 1150 (9th Cir. 1997), *cert. denied sub nom.* City and County of Honolulu v. Small Landowners, 119 S. Ct. 168 (1998); Hawaiian Leaseholders Equity Coalition v. Small Landowners, 119 S. Ct. 544 (1998)(upholding the Honolulu City Council's "lease-to-fee" ordinance challenged by the Bishop Estate and other landowners, but striking a rent control ordinance); COOPER & DAWS, *supra* note 51, at 422 ("It was mostly the lessees' reaction to Bishop's renegotiated rents in the early to mid-1970s that led to the additional legislation in 1975 that finally brought about sales."). Meanwhile, no statutory reform of commercial property occurred.

[53] The Estate's Lands, <http://www.ksbe.edu/estate/lands/lands.html> (updated Aug. 9, 1999)("Government Condemnation"). KSBE asserts that it lost $2 billion in these mandatory conversions. *Id.* Given the contrast between the identities of the KSBE beneficiaries and its lessees, one authoritative treatment of Hawaiian land politics scorns the notion of this so-called Maryland legislation as "land reform":

Service that these sales activities would neither jeopardize its tax exemption nor result in unrelated business income tax ("UBIT").[54]

The Estate then faced the dilemma of what to do with the estimated $2 billion generated by these sales.[55] KSBE invested in 300,000 acres of Michigan timberland; a bank in China; a majority interest in the Southern California Federal Savings and Loan Association; several golf courses; and

---

> What could in, say, 1960, have reasonably been called "land reform" through application of a Maryland-type law, redistributing land away from the more fortunate to the less, had by the 1980s come in a way to look like the opposite—a fairly prosperous group securing for itself by leasehold conversion a useful economic benefit, and over the objections of the representatives of a socially deprived and oppressed group.

COOPER & DAWS, *supra* note 51, at 412-13.

[54] *See* Anderson Report, *supra* note 47, at 273. From 1939 through March 1997, the Estate has received over 50 rulings from the IRS, most involving proposed real estate transactions. *Id.* *See, e.g.*, Priv. Ltr. Rul. 93-40-061 (July 16, 1993). While the identity of a taxpayer requesting a private letter ruling and other specific facts are redacted, the ensuing description of the applicant and of the litigation over state and local land laws suggests that the requesting taxpayer is KSBE. IRS General Counsel Memorandum 36,130 involves the land development activities of an unidentified Estate, "a perpetual trust created in *** [which] operates the *** Schools in ***[.] The Estate also owns and actively manages over 300 million acres of land, from which substantial rental income is derived." Gen. Couns. Mem. 36,130 (Jan. 6, 1975)("Facts"). (Assuming that the word "million" should be "thousand," the ruling appears to relate to the Bishop Estate; *see In re* Bishop Estate, 36 Haw. 403, 427 (1943)("The assets of Bernice P. Bishop Estate consist largely of real estate comprising an area of more than 378,000 acres.").) For a description of KSBE's residential property development, leasing, and sales from a federal income tax perspective, see TAKABUKI, *supra* note 51, at 102-05.

More intriguingly, former trustee Matsuo Takabuki claims credit (in alliance with Duke University) for a change to the Internal Revenue Code permitting educational institutions for the right (already granted to pension plans) to invest in leveraged real estate without triggering the tax on debt-financed investments. *Id.* at 105-10; *see* I.R.C. § 514(c)(9) (as amended in 1984). Takabuki declares:

> With the use of debt, the Estate could develop and redevelop its land for commercial, industrial, and residential use and it could leverage real property investment purchases. Understandably, then, the Bishop Estate led the effort among educational institutions to pass this amendment to the tax code in Congress. . . . This debt-financing amendment became an economic prop for the future development and expansion of the Estate's real estate holdings.

TAKABUKI, *supra* note 51, at 105-06. Takabuki explains how this law change enables KSBE to earn tax-free arbitrage profits because of its ability to borrow at low rates due to its excellent credit rating. *See id.* at 108.

[55] *See* Martin Kasindorf, *In Hawaii, a Loss of Trust in Once-Sacred Estate*, USA TODAY, Nov. 12, 1997, at 5A. *See also* John H. Taylor, *Hawaii's Royal Legacy*, FORBES, Dec. 21, 1992, at 177: "The trustees lost [the litigation against the state's land reform law]—but the timing was terrific. By the time the estate was forced to sell, property values in Hawaii had multiplied severalfold."

methane gas ventures.[56] As former trustee Matsuo Takabuki, responsible for much of this redeployment of assets, recalls:

> We diversified our investments in reinsurance, hospitals, managed health care, retailing, banking, regional convenience stores, oil and natural gas, and research companies in science and technology to spread the risk exposure over a wide and diversified field. The Bishop Estate was now being recognized as one of the 'big' players among tax-exempt institutions in the capital markets on Wall Street with a reputation for being knowledgeable and having the ability to move relatively quickly if necessary.[57]

The Bishop Estate is still the largest private landowner in Hawaii. *Souza v. Estate of Bishop*, 821 F.2d 1332, 1334 (9th Cir. 1987).[58] However, because 47% of KSBE's land is held for conservation and another 51% for agricultural use, most of KSBE's land revenue comes from the small percentage in commercial or residential use.[59]

Perhaps KSBE's most spectacular investment is its interest in the Goldman Sachs investment banking firm.[60] (While he was Treasury Secretary, Robert Rubin, a former Goldman Sachs partner, recused himself from all matters involving KSBE.)[61] Because Goldman was a partnership engaged in debt-

---

[56] *See* Susan Essoyan, *Shaken Trust: Wealthy Bishop Estate—Hawaii's Educational Benefactor—Comes Under Scrutiny and Criticism over Its Managerial and Ethical Practices*, L.A. TIMES, Nov. 9, 1997, at D1.

[57] TAKABUKI, *supra* note 51, at 113.

[58] As of 1985, "Trust lands comprise about 8% of the land area in the State and 15.1% of the lands on Oahu; about 2% of its total holdings are devoted to residential leaseholds. The estate owns 19.6% of Oahu residential land and 24.43% of that island's unimproved residential land." Hawaii Housing Auth. v. Lyman, 68 Haw. 55, 66 n.7, 704 P.2d 888, 894 n.7 (1985). *See also* Richardson v. City & County of Honolulu, 124 F.3d 1150, 1154 n.3 (9th Cir. 1995)("The City contends that the Bishop Estate owns approximately 20% of the condominiums on Oahu. The Bishop Estate does not refute this number.").

[59] *See KSBE Hawai'i Lands, available at* <http://www.ksbe.edu/estate/lands/landsmap.html>. As of June 30, 1996, KSBE's Website shows that it earns 92% of its income from its commercial property, 6% of its income from residential property, 2% of its income from agricultural property, and no income from the conservation property. *Id.*

[60] Former trustee Takabuki describes this investment without, however, disclosing the amounts invested or the percentage interest obtained. *See* TAKABUKI, *supra* note 51, at 113-19. Other reports put KSBE's total investment (part in 1991 and part in 1994) at $500 million; Goldman had approached its client KSBE for cash to finance the retirement of 40 profit-holding partners at a time of one of the worst downturns in bond history. *See, e.g.*, Tom Lowry, *Need for Capital Drove Original Deal*, U.S.A. TODAY, May 3, 1999, at B3.

[61] *See* Essoyan, *supra* note 56. In addition, Rubin paid the Bishop Estate large sums to insure him against the risk that his Goldman Sachs share would fall in value during his tenure at the Treasury Department. *See, e.g., Estate Guaranteed Rubin's Holdings*, HONOLULU STAR-BULLETIN, May 12, 1999, at B-1; Alix M. Freedman & Laurie P. Cohen, *Goldman's Big Hawaiian Investor Plays Clever Tax Game*, WALL ST. J., Apr. 25, 1995, at A1.

financed commercial activities, a direct equity interest would produce "unrelated business taxable income" to KSBE. Sec. 512(c). Accordingly, KSBE made the $500 million investment through a taxable subsidiary, which provided greater flexibility without additional tax cost.[62] However, returns to a corporate investment, in contrast to partnership income, would not result in unrelated business income tax to an exempt organization. Sec. 12(b)(1) (dividends), (5) (gain on sale of stock).[63] Accordingly, prior to Goldman's incorporation and initial public offering in May 1999, KSBE transferred its limited partner interest in Goldman Sachs from the taxable subsidiary to a tax-exempt affiliate called Kamehameha Activities Association.[64] The IRS and the Attorney General objected to this transfer of assets as offering the opportunity for KSBE assets to elude regulatory oversight, but a court-appointed special master approved the reorganization.[65] In Goldman's initial public offering, KSBE cashed out $477 million of its interest, leaving it with stock worth over $1.5 billion based on the value at the end of the first day of trading.[66]

Turning to expenditures for educational purposes, Kamehameha Schools admits only one out of eight applicants.[67] "Kamehameha still enrolls just under 7 percent of the children in the state of Hawaiian ancestry, the same percentage it did in the early 1960's with assets valued at a few hundred

---

[62] *See generally* TAKABUKI, *supra* note 51. Former Trustee Takabuki describes the income and deductions of this subsidiary. Reports of a potentially large tax bill for KSBE's taxable affiliates suggest that the IRS might be questioning the tax treatment of some of these transactions. *See, e.g.*, Rick Daysog, *Bishop Estate Faces $165 Million Tax Bill*, HONOLULU STAR-BULLETIN, Dec. 20, 1999, at A-1.

[63] Under the U.S. tax system, corporations as well as their shareholders pay tax, but partnership income flows through to the partners without tax at the partnership level; in the case of tax-exempt investors (either shareholders or partners) Congress wants to ensure one level of tax on income earned by the business entity.

[64] *See* Rick Daysog, *Estate Shifts Goldman Sachs Holdings to Nonprofit Corp*, HONOLULU STAR-BULLETIN, Oct. 21, 1998, at A-2; *see also* Form S-1, Goldman Sachs Group Inc. (filed with the Securities and Exchange Commission on Mar. 16, 1999), available on LEXIS at EDGARPlus. *See* I.R.C. § 512(b)(1) & (5). Presumably, KSBE's taxable subsidiary avoided gain on the transfer of this asset by closing the transaction before the effective date of the section 337(d) regulations. *See* T.D. 8802 (Dec. 29, 1998)(describing a January 28, 1999 effective date).

[65] *See* Rick Daysog, *Master Sides with Estate*, HONOLULU STAR-BULLETIN, Apr. 15, 1999, at A-2.

[66] *See* Rick Daysog, *Trust Makes a Bundle*, HONOLULU STAR-BULLETIN, May 4, 1999, at A-1.

[67] Kasindorf, *supra* note 55. "Rumors began that students had to have the right connections to be admitted—just like the ex-politicos who found their way onto the estate's payroll." Gail Diane Cox, *In Hawaii: A Princess, A Legacy, A Scandal*, NAT'L L.J., Jan. 11, 1999, at A1. "By February 1998, the state had notified the courts that it was broadening its investigation to include possible 'manipulation of the student admission process.'" *Id.*

million dollars."[68] In 1995, "citing a financial squeeze and consolidation of the estate's mission, the trustees eliminated community education programs that were reaching 10,000 people a year. Those shut out included public school children in largely Hawaiian areas, preschoolers and young parents."[69] In response, thousands of concerned alumni, parents, students and others formed a group to pressure for educational reform of KSBE, calling for reduced micro-management by Trustees in school operations.[70] Inspired by this group (called "Na Pua a Ke Ali'i Pauahi," or "Our Flowers of Princess Pauahi"), five prominent Hawaiians published an op-ed piece in the *Honolulu Star-Bulletin* called "Broken Trust"; its allegations of trustee mismanagement and conflict of interest prompted the governor to call for an attorney general investigation.[71]

However, KSBE asserts that it has been opening schools on the outer islands, and as of November 1997, 210 students were enrolled in temporary quarters.[72] KSBE justified its shift from outreach to new campuses by

---

[68] Purdum, *supra* note 23. *Cf.* TAKABUKI, *supra* note 51, at 125-26:

> One of the immediate major challenges remaining before the Bishop Estate is expanding the educational mission to include more Hawaiian children. The present campus provides an educational opportunity to only about 6 percent of eligible beneficiaries. Only one out of ten applicants of Hawaiian lineage is accepted to the schools. Kamehameha Schools does not, and cannot, meet all the educational needs of the Hawaiian community. . . . Kamehameha Schools' off-campus extension program was an attempt to meet this need to expand . . . . While assisting the public school system with troubled Hawaiian youth has been a costly program if analyzed on a cost-benefit ratio, this effort by the schools is important in meeting the educational needs of the Hawaiian community. . . .
>
> The trustees have considered building another campus to expand the educational outreach. During my tenure on the board, it was felt that the capital expenditure and eventual operating costs of such a campus would strain the funding capacity of the Estate. . . . The current board of trustees is moving forward with the construction of new schools . . . .

[69] Essoyan, *supra* note 56.

[70] *Id.*

[71] *See Broken Trust*, *supra* note 16. *See also* Lou Cannon, *Corruption Charges Catch Beloved Hawaii Charity in Furious Undertow*, WASH. POST, Dec. 23, 1997, at A3. "Proud that all board members claim at least some Hawaiian ancestry for the first time, native Hawaiians repeatedly squelched legislators' attempts to change the estate's business structure. What finally riled them was trustee handling of education." Kasindorf, *supra* note 55. According to *Broken Trust* co-author and University of Hawaii law professor Randall W. Roth, "'Anyone with any bit of Hawaiian blood has an emotional feeling toward the Bishop Estate[.]' . . . 'Anyone perceived as a threat runs the risk of losing a tremendous amount of political support from the native community.'" *Margery Bronster: Troublemaker*, GOVERNING, Dec. 1997, at 92. Lou Cannon commented: "Some observers link [the] new activism to a political and cultural awakening among Hawaiians that in the last decade has led to a call for restoration of Hawaii's national independence. The sovereignty movement has subsided, but the political consciousness it created in Hawaiians has lingered." Cannon, *supra*.

[72] *See* Essoyan, *supra* note 56.

explaining that it preferred to offer its own curriculum in its own facilities; moreover, "[i]n some of these [prior] programs, we were serving more non-Hawaiians than Hawaiians."[73]

KSBE annually prepares an account which is reviewed by a special master, who files a report with the probate court. In 1998 Arthur Andersen LLP ("Andersen"), a consultant retained by the special master and agreed to by KSBE, issued a report analyzing KSBE's investments and expenditures. Andersen found that KSBE rejected the 1987 advice of consultant Cambridge Associates, Inc., to establish a spending target based on 5% of endowment value. Andersen also criticized KSBE's investment practices—

> [T]he Trustees moved in a direction contrary to the adopted policy established in 1985 and its consultant's advice. With no apparent portfolio planning, the Trustees became more opportunistic and ad hoc and invested in high risk and illiquid non-Hawaii real estate ventures, private equity investments and oil and gas ventures. Much of this investing was done with little due diligence by the Estate and a heavy reliance on advice from their co-investors.[74]

In 1996, the Trustees failed to formally enact the strategic investment recommendations of Cambridge Associations. Moreover, Andersen found that the Trustees' investment due-diligence process "does not provide for any risk versus return assessment and appears to largely be a premium return seeking process de-emphasizing a balancing of the total risk exposure."[75] The Trustees failed to document their investment decisions, contributing "significantly" to poor investment results, and KSBE's practices lacked important aspects of best practices in the industry, including "evaluation of background investigations of sponsors and/or management, sufficient expertise to perform the due diligences, sharing of risks and rewards appropriately with sponsors, establishing reporting requirements and defining the exit strategies."[76]

---

[73] *Id.* (quoting KSBE spokesperson Elisa Yadao). In July 1999, the Interim Trustees (described below) announced an expansion of outreach programs, but an "attorney for one ousted board member . . . criticized the new board's decision . . ., saying that independent consultants have found the programs to be costly and ineffective in reaching their target native Hawaiian audience." Daysog, *supra* note 4.

[74] Andersen Report, *supra* note 47, sixth paragraph under "Management Audit—Summary of Significant Findings: Investment Planning," *available at* <http://www.napua.com/html/arthurexec.htm>.

[75] *Id.*, first paragraph under "Management Audit—Summary of Significant Findings: Investment Due Diligence".

[76] *Id.*, at third paragraph. In KSBE's exemption-application supplemental filing, *supra* note 28, the Interim Trustees describe reforms they intend to make to KSBE's spending and investment policies.

B. History of Trustee Compensation

Hawaii statutory law first provided for compensation to charity trustees in 1928. Commissions for the Trustees have been determined under Hawaii Revised Statutes §§ 607-18 and 607-20, which, until a recent amendment capping charity trustee fees at a "reasonable" level, set out specific formulas and limitations for allowable commissions. KSBE Trustee commissions have been calculated monthly based on cash received or paid by the Estate, with certain adjustments.[77] Specific questions under this formula have occasionally been litigated.[78] Commissions are examined annually during an independent audit and reviewed by a special master appointed by the probate court. The Trustees have waived commissions on: residential land sales as part of the fee sales program; educational revenue receipts; final disbursements of cash principal; and all capital receipts (effective July 1, 1995). In recent years, KSBE has commissioned outside studies of comparable compensation.[79]

Prior to the schedule adopted by the legislature in 1943, the Bishop Trustees had earned fees of about $10,000 a year. In 1943, the legislature grew concerned with the high administrative expenses of the Bishop Estate, including KSBE Trustee fees.[80] While the 1943 schedule initially cut fee levels in half,

---

[77] The following description comes from pages 317-21 of the Andersen Report, *supra* note 47. "Commissionable Revenue Receipts" include such items as rents; royalties, interest and dividends; partnership income; tax refunds; tuition and other educational income; and other fees. "Commissionable Capital Transactions" (net of realized capital losses) include capital gains on the sale or disposition of an investment; sale of original corpus lands; and disbursement of cash principal for construction, renovation and furniture, fixtures and equipment for school facilities.

[78] *See* Smith v. Lymer, 29 Haw. 169 (1926)(authorizing payment of commissions on amounts spent out of corpus to erect and equip new school buildings); *In re* Estate of Bishop, 37 Haw. 111 (1945)(allowing commissions to be paid on income from schools leased to the federal government for use as a hospital during wartime); *In re* Estate of Bishop, 53 Haw. 604, 499 P.2d 670 (1972)(holding that trustees are entitled to commissions on gross rents unreduced by real property taxes paid).

[79] The IRS included KSBE's payment for two studies in 1996 in the "Inurement" Notice of Proposed Adjustment, on the ground that the second study "served only to benefit the Incumbent Trustees by attempting 'to justify the amount of compensation they are currently being paid.'" Miller & Chevalier Letter, *supra* note 25, App. B, at 2-3.

[80] A Senate Judiciary Committee report compared expenditures on Kamehameha Schools unfavorably with expenditures on Punahou, then the elite school for *haoles* (whites). As Cooper and Daws related:

> The committee wrote that Punahou 1936-1941 had an income of $2 million, of which $1.7 million, or 85%, was spent on education, and that 5,730 students were taught. Kamehameha, on the other hand, through the Bishop Estate took in $4.3 million, of which $1.5 million, or only 35% was spent on education, and educated only 3,719 students. Although Kamehameha outspent Punahou on a per-student basis (about $400 to $300), still the drafters of the committee report seemed appalled at how little Bishop

by the late 1950s the fees had surpassed the earlier level. At this time, prominent politicians were becoming entangled with large landowners, including the Bishop Estate, in real estate development projects. In 1959 the legislature lowered the break points of the decreasing sliding scale, so that charitable trustees would be entitled 2% on income above $205,000. Meanwhile, the base on which the KSBE Trustees' fees were measured—trust income—grew along with property development activities. "Because of the new schedule and the development boom, each Bishop trustee got about $35,000 in 1960; in 1962 about $44,000; and by the early 1980s the five Bishop trustees between them were getting more than $1 million a year."[81]

Critics have charged that this connection between land development and the 1959 statutory increase in charitable trustee fees was more than coincidental: Might the Senate sponsor, who was in negotiations with the Bishop Estate to develop some of its land privately, have "felt in some way impelled to reciprocate for the opportunity that Bishop was offering him"?[82] Several prominent politicians later were named Bishop Estate trustees. (With the governor appointing the supreme court justices, until the recent change in trustee selection, the practice had continued.)[83]

Estate/Kamehameha was spending in comparison with what could be spent. *See* COOPER & DAWS, *supra* note 51, at 49. The Committee Report concluded that "the exorbitant cost of administering the Bishop Estate, the limited benefits received by the beneficiaries for whom Bernice [Pauahi] Bishop created the trust, have rendered long overdue this amendment to the statute awarding commissions to the trustees of charitable trusts." *Id.* (quoting SEN. STAND. COMM. REP. No. 241, 22d Leg., Reg. Sess. (1943), *reprinted in* 1943 HAW. SEN. J. 638, 640).

[81] *Id.* at 49-50 (footnote omitted).

[82] *Id.* at 51; *see also id.* at 50-53. Cooper and Daws also assert: "One clear consequence of Sen. Kido obtaining the agreement with Bishop was that it played a role in his voting 'no' in 1963 on a Democratic Party lease-to-fee conversion bill. The bill was to allow homeowners whose houses stood on lease land to compel their landlords to sell them the fee interest in the land. . . . The bill was defeated in the Senate by one vote." *Id.* at 52.

[83] *See id.* at 52-53 (describing appointment as Bishop Estate trustees of Matsuo Takabuki, "a leading member of the Honolulu Board of Supervisors and one of Gov. Burns' closest advisors"; William S. Richardson, "a Democratic Party leader"; and Myron B. "Pinky" Thompson, "a former aide to Gov. Burns"). *See also id.* at 53-55, Table 2 ("Burns and Other Mainstream Democrats and Democratic Appointees Who by 1970 Had Ties to Major Landowners"). This table describes the following investors in "Heeia Dev. Co. which had development agreement with Bishop Estate on 520 acres windward Oahu": Tadao Beppu, House Speaker; S. George Fukuoka, State Circuit Court Judge; James M. Izumi, Maui County Personnel Director; Hiroshi Kato, House Judiciary Chairman; Mitsuyuki Kido, Former State Senator and Honolulu Supervisor; Sunao Kido, Chairman State Board of Land and Natural Resources; Yoshikazu Matsui, Chairman Maui County Planning Commission; Matsuo Takabuki; and Mamoru Yamasaki, State Senator. The table also describes other politicians with development ties to the Bishop Estate: Duke T. Kawasaki, State Senator ("Investor Wiliwili Nui Ridge Subdivision (a partnership), which had development agreement with Bishop Estate"), and

In a 1972 review of KSBE trustee fees, the Hawaii Supreme Court displayed unhappiness with the consequences of the fee formula. While rejecting the Attorney General's attempt to reduce commissionable income by property taxes paid, the court declared: "We share the Attorney General's concern over the fact that the trustees' yearly commissions are increasing dramatically."[84] The court pointedly illustrated in a footnote:

> Previous to 1967 the Estate received an annual rental on the Royal Hawaiian Hotel property of $25,000 per year. Beginning in 1976, the annual rental will be increased to $1,170,000 per year. This increase alone will give each trustee an increase in additional yearly compensation of almost $4,600, and is but one example of the need for reevaluation of the schedule used to compute trustees' commissions.[85]

In response to public criticism, the trustees waived the commissions to which they were legally entitled for these land sales.[86] Indeed, former KSBE Trustee Matsuo Takabuki, named to the board in 1972, claimed that he had been making more in the private practice of law, but yielded to the appointment as a sacrifice to public service.[87] Twenty years later, *each* trustee received about $860,000, and by 1998 was drawing in excess of $1 million.[88]

Herman T.F. Lum, State Circuit Court Judge, holder of two office-building Bishop Estate leases. *See also id.* at 56-59, Table 3 ("Legislative Leaders 1955-1984 Real Property Investment and Development Activity, Affiliations with Major Landowners and Developers")(describing Henry H. Peters, Bishop Estate trustee, as House Speaker 1981-84, and director of a Hong Kong-owned company formed to do real property business in Hawaii). In 1993 (subsequent to publication of Cooper and Daws' book), Richard S.H. ("Dickie") Wong, who was a former Senate president, was named a Trustee. *See, e.g., Top Trustee Indicted at Big Charity*, CHRON. PHILANTHROPY, Apr. 22, 1999, at 58.

[84] In re *Estate of Bishop*, 53 Haw. 604, 606, 499 P.2d 670, 672 (1972).

[85] *Id.* at 606 n.3, 499 P.2d at 672 n.3.

[86] *See, e.g.*, Wallace Turner, *Hawaii Trust Wields Unusual Power*, N.Y. TIMES, July 17, 1983, Sec. 1, at 30 (stating that the trustees waived $885,000 since sales of residential leaseholds to homeowners began in 1979).

[87] In his autobiography, Takabuki relates his meeting with Supreme Court chief justice William S. Richardson and associate justice Bert Kobayashi:

> "How much does a trustee earn?" I then asked. The figure was quite a bit less than what I was earning in my practice. Bert then intervened, saying, "Don't tell me about the financial sacrifice you will be making. Remember the sermon you and the governor gave me about public service? You knew I was making a big financial sacrifice when I became attorney general."

TAKABUKI, *supra* note 51, at 95-96.

[88] *See* Petition for Removal of Trustees, *supra* note 28, at 19. Specifically, each trustee received $860,653 in FY 1992, $823,974 in FY 1993, $915,238 in FY 1994, $938,047 in FY 1995, $823,706 in FY 1996, $844,599 in FY 1997, $1,037,011 in FY 1998, and $735,420 through the first nine months of FY 1999. *Id.* at 19, ¶¶ 71 & 72.

In May 1998, the Hawaii legislature enacted a new limitation for charity trustees:[89] Henceforth, trustee compensation must be "reasonable under the circumstances." Haw. Rev. Stat. § 607-20 (as amended by L. 1998, ch. 310 § 2). In January 2000, probate judge Kevin Chang held a hearing on a recommended cap of $97,000 per trustee ($120,000 for the chair).[90]

C. Current Tax Dispute

In 1939, the IRS recognized KSBE as a charitable organization under what is now section 501(c)(3); in 1969, the IRS recognized KSBE as an educational organization.[91] The IRS subsequently recognized KSBE as a non-private foundation under section 170(b)(1)(A)(ii).[92]

The IRS's examination of KSBE and its taxable subsidiaries covers the fiscal tax years ended June 30, 1992, through June 30, 1996.[93] The IRS examined five issues: trustee compensation, benefits, and expense reimbursements; lobbying activities; the relationship of Estate expenses/activities to exempt purpose; the school's racially nondiscriminatory policy; and intercompany transactions involving the Estate and its taxable affiliates.[94]

In the early 1990's, the IRS District Office requested a technical advice memorandum from the National Office regarding the reasonableness of the Trustees' compensation. "Estate personnel and Price Waterhouse stated that the request was returned by the National Office of the IRS to the field agents since it was a question of fact rather than law."[95] The Service is reported to be separately considering application of section 4958 "excess-benefit" taxes against the individual Trustees.[96] Because of potential conflicts of interest,

---

[89] The new regime, effective January 1, 1999, falls far short of one version urged by reformers. In 1997, Governor Benjamin Cayetano announced his plan to introduce a bill to cap trustee compensation—and "called on the chairman of the Judiciary Committee of the Hawaii House of Representatives, who is on a $4,000-a-month legal retainer with Bishop Estate, to recuse himself on the issue." Essoyan, *supra* note 56. "During conference talks, the House rebuffed the Senate's compromise of setting trustee pay at $94,780 annually—what Hawaii's chief justice is paid. Instead, the House insisted a task force study compensation of trustees for various charitable trusts." Mike Yuen, *Case Pushes for House Vote to Limit Trustee Salaries*, HONOLULU STAR-BULLETIN, May 5, 1998, at A-8.

[90] *See* Daysog, *supra* note 22.

[91] *See* IRS Determination Letter to The Bernice P. Bishop Estate, Apr. 16, 1969, at 2, *available at* <http://www.ksbe.edu/news&info/tax_info/exempt_ltr.html>.

[92] *See* Andersen Report, *supra* note 47, at 272 (describing 1970 ruling on non-private foundation status).

[93] *See id.* at 272.

[94] *See id.* at 274.

[95] *Id.* at 287.

[96] *See, e.g.*, Stephen G. Greene, *Trustees Ousted in Hawaii*, CHRON. PHILANTHROPY, May

Probate Judge Kevin Chang approved a motion by Trustee Oswald Stender to appoint "Special Purpose Trustees" to act on behalf of KSBE in negotiating for a closing agreement with the Service.

On May 4, 1999, Terry Franklin, Chief of the Employee Plans/Exempt Organizations Division in the IRS Western Key District, and Marcus Owens, Director of the Exempt Organizations Division in the IRS National Office, wrote to the Special Purpose Trustees.[97] This letter confirmed that the resignation or removal of the five incumbent trustees is, as Judge Chang later characterized it, a "non-negotiable" condition precedent to entering into negotiations for a closing agreement and preventing revocation of exemption.[98]

20, 1999, at 30 ("[A]t least four of the five former trustees are widely expected to face hefty fines imposed by the I.R.S. under a 1996 law that allows the agency to penalize charity officials who receive overly generous financial benefits.").

[97] Letter to the Special Purpose Trustees, Kamehameha Schools/Bernice Pauahi Bishop Estate, from Marcus S. Owens, Director, Exempt Organizations Division, Internal Revenue Service, and Terry Franklin, Chief, EP/EO Division, Western Key District, Internal Revenue Service (May 4, 1999), identified by stamp as Exhibit B (no date) [hereinafter IRS Letter to Special Purpose Trustees].

[98] Removal Order, *supra* note 2. The IRS's letter reads, in relevant part:

1. With respect to the status of the trustees, it is our position that the Estate lacks internal controls and the requisite fiduciary oversight to ensure that only activities appropriate for a tax exempt charity occur. In our view, the inappropriate expenditures and other uses of funds are ongoing and include, but are not limited to, continuing payment of excessive compensation. Given the absences of effective internal controls and oversight, there is little to prevent the continuing misuse of assets and the possible movement of assets beyond the jurisdiction of the Service, perhaps in the guise of legitimate investment activities. *Consequently, it is of critical importance that you understand that as long as the five incumbent trustees are in a position to direct the Estate's operations, the Service believes that the assets are at risk. Should we receive indications that such movement is being contemplated, we will terminate any negotiations that are underway, revoke federal income tax exemption, and otherwise move to protect the interests of the federal government.* Interim removal of the incumbent trustees will ensure a stable environment for closing agreement discussions and clearly demonstrate the bona fide nature of negotiations on behalf of the Estate. Such interim removal is a clear signal of the sort required by the Service in order for negotiations to proceed. Please be advised that so long as such action is not taken, there is a very real risk that an intentional or inadvertent indication of a transfer of assets will trigger immediate and decisive action by the Service. Because of the ability to move funds rapidly and electronically, it is highly unlikely that the Service would be able to differentiate between intentional and inadvertent indications of a transfer before having to initiate action.

2. Furthermore, it is absolutely necessary as a precondition to negotiations that the scope of the Special Purpose Trustees' authority be clarified to encompass all subsidiaries and related or controlled organizations, whether tax exempt or taxable, including but not limited to, Kamehameha Activities Association. The Service will require that all parts of the Kamehameha Schools/Bishop Estate "family" be subject to the terms and conditions of any closing agreement to ensure that operations in the future are appropriate.

On May 7, 1999, Probate Judge Chang accepted the interim resignation of trustee Oswald Stender and ordered the temporary removal of the other trustees.[99] Judge Chang found credible the Internal Revenue Service's threat that unless all five trustees resigned or were removed, the Service would move to revoke KSBE's exemption. Judge Chang installed the five Special Purpose Trustees as "Interim Trustees."

In the context of Probate Court proceedings to reform KSBE's governance and management structure, and conditioned on the removal of the Incumbent Trustees, Judge Change approved a closing agreement between KSBE and the IRS on December 1, 1999.[100] Shortly thereafter, however, the probate court held a lengthy trial (only recently concluded, without yet a ruling) on the Interim Trustees' petition for permanent removal of the Incumbent Trustees. Even though the court left the Interim Trustees in place pending resolution of that case, the Internal Revenue Service revoked the closing agreement at the outset of that trial. Specifically, following a technical advice memorandum issued by the IRS National Office,[101] on December 31, 1999 the Western Key District director issued a final notice of revocation of KSBE's favorable

---

3. Any closing agreement must set forth the structure or outline of a systematic process for selecting qualified trustees. We understand that actual implementation of such a system and selection of new trustees may require some time to effectuate and that some form of interim governance may be necessary as a practical matter.

4. Any closing agreement will cover all tax years beginning with the first year under examination, 1990, and will extend forward in time for an appropriate period. The organizational and operational changes that will be incorporated into a closing agreement will also be reflected in a new application for exemption, Form 1023, to ensure that the protections as delineated will become conditions of exemption from federal income tax and, as such, have legal significance after the specific term of the closing agreement. We hope that the preceding clarification of our views is helpful but should be understood to identify broad categories of change that will be necessary. The Service will require significant and specific actions implementing the general requirements. Any negotiated resolution of federal tax concerns must also address such matters as investment policy, procedures for ensuring that appropriate resources are actually expended on charitable activities, and prohibitions on questionable expenditures.

IRS Letter to Special Purpose Trustees, *supra* note 97 (emphasis in original).

[99] Removal Order, *supra* note 2.

[100] Order Approving Settlement, *supra* note 11. [Reminder: The entire remainder of this paragraph in the text—written after the permanent resignation of all five trustees—is fiction!]

[101] *See* Lawrence M. Brauer & Marvin Friedlander, *Section 4958 Update*, IRS EXEMPT ORG. CPE TEXT FOR FY 2000, ch. B (Aug. 31, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 169-13 (Sept. 1, 1999)(explaining that key district offices and appeals offices must request technical advice from National Headquarters in "[a]ll cases in which an adverse action under an inurement proscription is being proposed" and "[a]ll private inurement cases that are being considered for resolution by closing agreement"). However, a technical advice memorandum revoking exemption is not a public document, unless it deals with issues other than revocation. *See* I.R.C. §§ 6110(k)(1), 6104; Treas. Reg. § 301.6104(a)-1(i) (1982).

determination letter, on a prospective basis. The notice of revocation reads, in relevant part, as follows:

> We have completed our review of your activities, and examination of your Forms 990, for the years ending June 30, 1990, and all later filed years. By this letter I am formally informing you that the Internal Revenue Service is revoking, effective immediately and on a prospective basis, the recognition of the Bernice Pauahi Bishop Estate and Trust (Estate), as an entity exempt from Federal Income taxes under section 501(a) of the Internal Revenue Code (Code), as an organization described in section 501(c)(3) of the Code. The National Office concurs in this decision pursuant to our request for technical advice. The reasons for this determination are as follows:
>
> (1) By failing to spend its income on current operations, the Estate is not operating a charitable program commensurate in scope with its financial resources.
>
> (2) The compensation paid to the trustees amounts to excess benefit transactions between the Estate and its disqualified persons; along with self-dealing by the trustees, these instances of private inurement are so significant that revocation of exemption is appropriate.
>
> Contributions to you are no longer deductible under section 170. . . .

Petitioner has exhausted its administrative remedies within the Internal Revenue Service. As required by section 7428(b)(3), the petitioner's complaint was filed before the 91st day after the date of mailing of the determination letter notifying petitioner of the revocation of its tax-exempt status under section 501(c)(3). This Court is empowered to issue declaratory relief.

II. DISCUSSION

A. Legal Framework

As charity operations grow more important in our economy, and as pressures on the Internal Revenue Service increase to fill gaps left by State regulators, the regulation of charities has raised questions of federalism.[102] That is, the question is not so much, "What is the right result?", but rather,

---

[102] *See generally* Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 480-84 (1996)(describing proposals for a uniform law of charity, under a central regulatory authority); Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1434-40 (1998)(describing the regulation of charity fiduciaries through the federal tax system).

"Which level of government should obtain the right result?" Often by default, due to the inaction of State attorneys general, the public has come to expect the Internal Revenue Service to keep charities on the straight and narrow path. However, even after recent legislation dealing with "excess benefits" paid to charity insiders, Congress has never given the Service broad equity powers over nonprofit organizations.

Accordingly, we introduce the legal issues by providing an overview of the powers Congress grants the IRS in the regulation of section 501(c)(3) organizations (collectively referred to as "charities"). Notably, we distinguish between the detailed rules that apply to fiduciaries of "private foundations" (which KSBE is not) and the more general rules that apply to fiduciaries of "public charities" (which include KSBE).

Section 501(c)(3) describes entities that are organized and operated "exclusively" for a religious, charitable, or educational purpose. *See also* sec. 1.501(c)(3)-1, Income Tax Regs. The regulations soften the absolute standard in the statute by requiring the entity to be engaged "*primarily* in activities which accomplish one or more of such exempt purposes." Sec. 1.501(c)(3)-1(c)(1), Income Tax Regs. (emphasis added). The respondent does not contend that petitioner is organized for other than an exempt purpose. Rather, the respondent asserts that KSBE is not primarily operated for an exempt purpose.

The Code imposes the additional constraint that an organization is described in section 501(c)(3) only if "no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual." For purposes of this prohibition on private inurement, the regulations define "private shareholder or individual" rather unhelpfully as "persons having a personal and private interest in the activities of the organization." Secs. 1.501(c)(3)-1(c)(2) & 1.501(a)-1(c), Income Tax Regs. Judge Posner recently cut to the heart of the private inurement prohibition: "A charity is not to siphon its earnings to its founder, or the members of its board, or their families, or anyone else fairly to be described as an insider, that is, as the equivalent of an owner or manager." *United Cancer Council Inc. v. Commissioner*, 165 F.3d 1173, 1176 (7th Cir. 1999).

Respondent asserts two distinct bases for revoking KSBE's exemption: (1) that KSBE allows its assets to inure to the benefit of its Trustees, and (2) that KSBE fails to conduct a charitable program "commensurate in scope" with the organization's charitable resources. The first charge essentially says to the organization: "What you're spending, you're spending for a private rather than a public purpose." The second charge essentially says to the organization: "What you're earning, you're not spending enough for charity now."

These two charges overlap in this case. Following the lead of the Hawaii attorney general, the respondent asserts that the KSBE Trustees minimized operating expenses and focused on reinvesting surplus in order to produce investment income, presumably to generate a high base on which trustee fees are measured.[103] Similar misuse of some family foundations prompted the enactment of the Tax Reform Act of 1969. In the 1960's Congress grew concerned that wealthy individuals were establishing "private foundations" in order to hold unproductive real estate or stock in the family business. The foundation would make few demands for income, either in the form of rents or dividends, and would carry on minimal charitable activities. The assumed real purpose of the foundation was to control the assets for the benefit of the family.

In 1969, Congress adopted a set of excise-tax rules designed to induce private foundations to make productive, prudent investments, and to pay out a minimum percentage of investment assets for charitable purposes. Under the current version of the payout rule, a private foundation must annually dispense at least 5% of the value of its net investment assets for charitable purposes. Sec. 4945.[104] In addition, a private foundation may not make investments that jeopardize its charitable purpose. Sec. 4944. While private foundations remain subject to the general section 501(c)(3) prohibition on private inurement, section 4941 imposes a penalty tax on a foundation "self-dealer" and on the foundation manager who knowingly participated in specified acts of self-dealing. The statute carves out the "payment of

---

[103] *See* Petition for Removal and Surcharge, *supra* note 48 (Count 1, "The Trustees Have Violated the Directives of the Will and the Purpose of the Trust: Depriving Kamehameha Schools of Annual Income," fortieth to forty-third paragraphs):

> 40. The Trustees at all times during the terms of Stender, Wong, Lindsey, and Jervis and during the last 13 years of Peters' term have accumulated $350 million in income directed by the Will for the use of Kamehameha Schools and then depleted the accumulated income by reclassifying it as corpus.
>
> 41. The Trustees calculated their compensation on the Trust income while it was classified as income and before it was later reclassified as corpus.
>
> 42. The reclassification of Trust income as corpus was not disclosed to the Beneficiaries and was not disclosed to the court.
>
> 43. The effect of the reclassification has been to subvert the single purpose of the Trust, to necessitate reductions in educational programs and services, to deprive thousands of children of the opportunity to obtain educational benefits from the Trust, and to deprive the Kamehameha Schools of $350 million intended by Ke Ali'i Pauahi to educate Hawaiian children.

[104] Moreover, under the prohibition on "excess business holdings," a private foundation cannot own more than 20% of the stock of company (counting the shares of "disqualified persons"). *See* I.R.C. § 4943. *See generally* Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873, 925-26 (1997) [hereinafter Brody, *Charitable Endowments*].

compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation . . . if . . . not excessive." Sec. 4941(d)(2)(E).

Under the 1969 regime, every section 501(c)(3) organization is presumed to be a private foundation unless it fits within a statutory exclusion. (Non-private foundations are often referred to as "public charities.") The distinction generally rests on the sources of support for the organization: Where an organization enjoys broad support from the general public, the marketplace for donations and other patronage can substitute for tight regulatory oversight and controls. However, Congress also created several types of *per se* public charities, regardless of their sources of support or any third-party oversight. Importantly, KSBE is not a private foundation because it is a school. Sec. 509(a)(1) and 170(b)(1)(A)(ii).[105] But for this statutory exclusion, KSBE would be classified as a private foundation, given that more than one-third of its income comes from investments. *See* sec. 509(a)(2). Accordingly, sections 4942 through 4945 do not apply here.

From time to time policy makers considered extending private-foundation-type rules to public charities.[106] In 1977, the Treasury Department proposed that public charities "would be required to spend or distribute annually for

---

[105] To be precise, section 170(b)(1)(A)(ii) describes "an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on . . . ."

[106] An influential study commission in 1977 recommended extending a minimum payout regime to public charities. *See* COMM'N ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS (JOHN H. FILER, CHAIRMAN), TREASURY DEP'T., COMMENTARY ON COMMISSION RECOMMENDATIONS, DONEE GROUP REPORT AND RECOMMENDATIONS, *in* 1 RESEARCH PAPERS 28-29 (1977). In the case of an operating charity, though, such a requirement could be fairly easy to satisfy, as indicated by the Filer Commission's commentary on its proposal:

> Public charities are not currently subject to any payout requirement, and at least one well publicized instance has come to light in which a charitable organization has amassed large financial holdings while doing little to expand its charitable activities. So the Commission believes that a payout rule is desirable for other endowed charities as well as for foundations. For organizations other than private foundations, however, the payout rate should be set at a smaller percentage and it should be satisfied by the use of funds for the direct conduct of the organization's activities, including the acquisition, construction or repair of buildings or other facilities, the acquisition of art objects by museums, and so forth. Accumulations, in fact, should be liberally allowed for purposes that clearly further the organization's tax-exempt functions and services.

REPORT OF THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTOR 176 (1975). For a discussion of the administrative difficulties of imposing a minimum payout requirement on public charities, see Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687, 723-26 (1999).

charitable purposes at least 3-1/3 percent of their noncharitable assets."[107] Perhaps more radically, the Treasury also advocated investing the United States District Courts with a range of equity powers. The Treasury Department introduced this latter proposal with the following general description:

> United States District Courts would be invested with (1) equity powers (including, but not limited to, power to rescind transactions, surcharge trustees and order accountings) to remedy any detriment to a philanthropic organization resulting from any violation of the substantive rules, and (2) equity powers (including, but not limited to, power to substitute trustees, divest assets, enjoin activities and appoint receivers) to ensure that the organization's assets are preserved for philanthropic purposes and that violations of the substantive rules will not occur in the future.[108]

This proposal specified that the federal courts would defer to any State equitable proceedings:

> In the event that appropriate State authorities institute action against a philanthropic organization or individuals based upon acts which constitute a violation of substantive rules of law applicable to such organization, the United States District Court before whom the federal civil action is instituted or was pending would be required to defer action on any equitable relief for protection of the organization or preservation of its assets for its philanthropic purposes until conclusion of the State court action. At the conclusion of the State court action, the District Court could consider the State action adequate or provide further equitable relief, consistent with the State action, as the case warrants. However, no action by a State court would defer or abate the imposition of the initial Federal excise taxes for the violations.[109]

Congress did not enact these 1977 proposals.

But pressure continued to build for some "intermediate" sanction for fiduciary infractions. Most worrisome was the absolute bar on private

---

[107] *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) [hereinafter 1977 Treasury Proposal]. The only public charities subject to a payout requirement—of 3.5%—are "medical research foundations." Treas. Reg. § 1.170A-9(c)(2). This rule was created as a compromise for the wealthy Howard Hughes Medical Institute, which wrangled for years with the Service over its qualification for public charity status. *See, e.g.*, Bill Richards, *Hughes Institute Wins Round at IRS*, WASH. POST, Jan. 20, 1979, at A4 ("In September 1970 the institute requested tax-exempt status under the 1969 act as a public medical research charity. . . . Like a number of the other specific exemptions it was carefully tailored for just one organization—in this case the Hughes Medical Institute.").

[108] 1997 Treasury Proposal, *supra* note 107, at Technical Explanation, part 1.C.1.b.(2)(a), at 70,855 (Improving the Philanthropic Process, Enforcement Procedures, Alternative Sanctions, Treasury Proposal, Detailed Description, Equity Powers).

[109] *Id.* at part 1.C.1.b.(2)(c), at 70,856.

inurement: In theory, a single dollar of private inurement threatens the ultimate sanction—loss of tax exemption. *See Founding Church of Scientology v. United States*, 412 F.2d 1197, 1202 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970) ("Congress, when conditioning the exemption upon 'no part' of the earnings being of benefit to a private individual, specifically intended that the amount or extent of benefit should not be the determining factor."); *Airlie Foundation, Inc. v. United States*, 55 F.3d 684 (D.C. Cir. 1995)(unpublished opinion)(the inurement prohibition does not require a showing of harm to the organization).[110]

In cases of inurement, however, revocation of exemption compounds the harm to the bilked charity instead of punishing the wrongdoers. Hence, the Service hesitates to carry out this authority, acting only in such egregious cases as the PTL church, brought down by the greed of its minister Jim Bakker and his wife Tammy Faye Bakker.[111] Instead, the Service usually bent over backwards to avoid finding irremediable private inurement, preferring to work out changes in governance and compensation via "closing agreements" with the entities and their fiduciaries.[112] Closing agreements, however, occur only

---

[110] For an in-depth examination of the policy behind and mechanics of the private inurement prohibition, see Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. __ (forthcoming 2000).

[111] *See* Teague v. Bakker, 35 F.3d 978, 984 (4th Cir. 1994), *cert. denied*, 1995 U.S. LEXIS 1088 (Feb. 21, 1995). The court noted that "in late 1983, PTL fell prey to an IRS audit which culminated in PTL being stripped of its tax-exempt status. The IRS took this action in part due to private inurement allocated to Bakker and Tammy. The loss of tax exempt status threatened to create huge tax liabilities and to leave PTL unable to attract the deductible contributions which were its lifeblood." *Id.* at 984. For a description of PTL's rise and fall—including James Bakker's 5-year compensation of nearly $4.5 million, Tammy Faye Bakker's compensation of over $1.1 million over this period, and lavish living expenses, as well as the amounts claimed by the IRS as resulting in private inurement—see the decision in PTL's bankruptcy case, *In re* Heritage Village Church & Missionary Fellowship, Inc. a/k/a PTL, 92 B.R. 1000 (Bankr. D.S.C. 1988).

[112] Best known is the settlement between the Service and the Church of Scientology, including all of its constituent entities. *Compare* Founding Church of Scientology v. United States, 412 F.2d 1197, 1199, 1201 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970)(payments to founder L. Ron Hubbard of 10% of gross income of affiliated Scientology organizations "were disguised and unjustified distributions of plaintiff's earnings"); *and* Church of Scientology v. Commissioner, 823 F.2d 1310, 1317 (9th Cir. 1987)("[T]he payments in this case cross the line between reasonable and excessive."), *id.* at 1317, *aff'g* 83 T.C. 381 (1984), *with* Closing Agreement on Final Determination Covering Specific Matters (Oct. 1, 1993), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 97 TNT 251-24 (Dec. 1, 1997)(note that this document was leaked, and never acknowledged by either party). The introduction to Part VI.A of this putative closing agreement states: "it is intended that the consensual sanctions set forth in this section are to provide the Service with intermediate sanctions for activities or conduct not in accordance with the provisions of Code section 501(c)(3) for which revocation of recognition of exemption may be too harsh or otherwise

in the enforcement process and are negotiated on a case-by-case basis; thus they fail to set forth a systematic set of rules binding on exempt organizations and the government, even when the IRS make public disclosure a condition of the closing.[113]

In recent years, congressional bodies held hearings on various pro-posals for intermediate sanctions, short of revocation of exemption, that would apply to public charities.[114] In 1994, Congressman J.J. Pickle, chair of the Oversight Subcommittee of the House Ways and Means Committee, issued a report on proposed reforms.[115] The Pickle Report found: "With regard to revocation of tax-exempt status, in 1991 and 1992, IRS revoked the tax-exempt status of 60 section 501(c)(3) organizations. Private inurement was the reason for revocation of the exemption of 20 organizations, [and] failure to operate as a section 501(c)(3) organization was the reason for 16 revocations. . . ." Obvious-ly, in a universe containing over 500,000 section 501(c)(3) organizations, the exemption of most organizations is safe. Discussing the difficulty of administering a regime in which revocation exists as the only sanction, the Pickle Report quoted from the testimony of the Commissioner of Internal Revenue:

> The Commissioner testified that "lack of a sanction short of revocation in cases in which an organization violated the inurement standard or one of the other standards for exemption causes the Service significant enforcement difficulties. Revocation of an exemption is a severe sanction that may be greatly disproportional to the violation in issue." * * *
>
> To illustrate the dilemma facing IRS, the Commissioner cited the case of a hypothetical university which revealed serious questions of private inurement regarding the university's president, including a salary that appeared excessive, a substantial interest-free loan, and costly amenities in the official residence. To

---

inappropriate as a sanction . . . .". *Id.* at VI.A.

[113] *See also* Peter Frumkin & Alice Andre-Clark, *Nonprofit Compensation and the Market*, 21 U. HAW. L. REV. 425, 457 n.178 and accompanying text (quoting the 1993 testimony of then-IRS Commissioner Margaret Richardson before the Subcommittee on Oversight that with closing agreements "it is difficult to ensure that similar organizations are treated consistently").

[114] *See generally* Marion R. Fremont-Smith, *Current Proposals for Public Charity Intermediate Sanctions*, 10 EXEMPT ORG. TAX REV. 115 (July 1995)(describing 1991 proposals for health care organizations, a 1992 proposal by the IRS Penalty Task Force, and a 1993 formal request to Congress by the Commissioner of Internal Revenue in testimony before the Oversight Subcommittee of the House Ways and Means Committee); Harry G. Gourevitch, *Congressional Research Service Report on the Tax Treatment of Exempt Organizations: Intermediate Sanctions* (CRS 94-901 S, Nov. 15, 1995), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 95 TNT 64-60 (Apr. 3, 1995).

[115] WAYS AND MEANS OVERSIGHT SUBCOMMITTEE, REFORMS TO IMPROVE THE TAX RULES GOVERNING PUBLIC CHARITIES (May 5, 1994), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 94 TNT 89-7 (May 9, 1994).

> address these problems by revocation would adversely affect the entire university community. Moreover, even if IRS were to revoke the university's tax-exempt status, the president's salary and fringe benefits would not be affected.[116]

Based on this and other testimony and evidence, the Oversight Subcommittee concluded:

> The Subcommittee believes that, due to the severity of the revocation sanction in cases of private inurement, IRS has been reluctant to impose it. As a result, IRS enforcement is adversely affected and charity officials are able to undertake certain questionable activities knowing it is unlikely that such activities will result in loss of the organization's tax exemption. Further, the Subcommittee is concerned that current IRS enforcement tools are not appropriate because revocation of an organization's tax-exempt status adversely affects the beneficiaries of the public charity, rather than the individuals who engaged in and benefited from the self-serving transactions.[117]

A week after the May 1994 Pickle Report came out, members of the Exempt Organizations Committee of the American Bar Association Section on Taxation released comments on the various proposals.[118] They observed:

> [I]n recent years, the Service increasingly has utilized closing agreements as a means of imposing what is in practical effect an intermediate penalty. Because the circumstances surrounding the use of closing agreements are subject to the confidentiality provisions of IRC section 6103, the public is rarely made aware of this process. Accordingly, it is difficult to evaluate the extent to which the closing agreement process alleviates the need for a formal intermediate sanction or the extent to which it could do so if closing agreements were made more public.[119]

---

[116] *Id.*

[117] *Id.*

[118] Members of the ABA Tax Section Exempt Organizations Committee, *Comments on Compliance with the Tax Laws by Public Charities* (May 11, 1994), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 94 TNT 105-25 (June 1, 1994).

[119] *Id. See* I.R.C. § 7121 (closing agreements); Tax Analysts v. Internal Revenue Serv., 53 F. Supp. 2d 449 (D.D.C. 1999)(holding that closing agreements relating to tax exemption are not subject to disclosure). *See also* Peter J. Meadows & William A. Dobrovir, *Who Killed Guidance?*, 73 TAX NOTES 221 (Oct. 14, 1996)("The secrecy of exempt organization closing agreements raises an important policy question" because "the danger exists that the Service may treat similarly situated charitable organizations differently[.]"). In a few notable cases, including this one, the Service insisted that the organization agree to publicize either the closing agreements themselves or a summary. *See id.* (describing the Hermann Hospital closing agreement that allowed a hospital which offered improper physician recruitment incentives to retain its exemption, but requiring it to pay $1 million, the amount of federal tax it would have paid if taxable; and the closing agreements with Jimmy Swaggart Ministries and with Christian Broadcasting Network regarding prohibited political activity). In January 2000, the Joint Committee on Taxation recommended that exempt-organization closing agreements be made

In addition, the ABA members cautioned that if intermediate sanctions are adopted for some, but not all, requirements of section 501(c)(3), "the Service would be relegated to its current status of asserting revocation, attempting to obtain a closing agreement, or not penalizing the violation, although an intermediate sanction may be the more appropriate option."[120]

Finally, in 1996, Congress enacted a set of intermediate sanctions for public charities. Sec. 4958.[121] While the new rules adopt a penalty excise tax approach similar to that already applicable to private foundations, important differences exist. Most significantly, the intermediate sanctions rules apply only to the portion of a transaction that results in private inurement under prior law. (Not all payments to insiders result in "inurement" of profits; since charities are permitted to pay the expenses of their operations, the issue usually arises in cases of excessive payments.) None of the other private foundation taxes, such as the minimum payout rules or taxes on jeopardizing investments, were extended to public charities.

An "excess benefit" transaction occurs when the charity directly or indirectly provides an economic benefit to or for the benefit of the insider and "the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit." Sec. 4958(c)(1)(A).[122] In such a case, the rules apply a two-tier tax scheme. The first-tier tax on the insider is 25% of the excess benefit portion. Sec. 4958(a)(1).[123] The real purpose of this first-tier tax, however, is to induce the benefited insider to disgorge the excess benefit to the charity: The second-tier tax—which applies if the transaction is not "corrected"—is a confiscatory 200% of the excess benefit, to be paid by the benefited insider. Sec. 4958(b).[124] The IRS has the authority to abate the first-tier penalty taxes

---

public, without redaction of taxpayer identifying information. *See* JOINT COMM. ON TAX'N, *supra* note 31. For an opposing view, see Letter from T.J. Sullivan to Tax Analysts (Jan. 15, 1998), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 98 TNT 13-34 (Jan. 21, 1998)("I fear that the Service will be less willing to compromise and taxpayers will be less willing to acknowledge error if closing agreements are made public.").

[120] Members of the A.B.A. Tax Section, *supra* note 118.

[121] The rules apply to excess benefit transactions after September 14, 1995, unless the transaction is pursuant to a binding contract in effect on September 13, 1995 and continuously until the transaction occurred.

[122] Certain "revenue-sharing" transactions can also trigger intermediate sanctions, even in the absence of an excess benefit. As discussed below, the Incumbent Trustees' fees might be considered a revenue-sharing transaction.

[123] The participating "organization manager" is separately subject to a tax of 10% of the excess benefit, but only if his or her participation is willful and not due to reasonable cause. I.R.C. § 4958(a)(2) (providing that a personally benefited organization manager could be subject to both taxes). Moreover, the managers' combined liability per excess benefit transaction cannot exceed $10,000. I.R.C. § 4958(d)(2).

[124] No second-tier tax applies to the organization manager.

if the violation was due to reasonable cause and not willful neglect, and the wrongdoer corrects the transaction promptly upon notice from the IRS. Sec. 4962. Correction means "undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person had been dealing under the highest fiduciary standards." Sec. 4958(f)(6).

To date, guidance on these provisions is limited to the legislative history in the House report to H.R. 2337, the "Taxpayer Bill of Rights 2," and to regulations proposed by the Treasury Department and Internal Revenue Service in August 1998. *See* H.R. Rep. No. 104-506, at 51, 53-61 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143, 1174, 1176-84; Notice of Proposed Rulemaking, "Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions," 63 Fed. Reg. 41,486 (Aug. 4, 1998).[125]

We now turn to the two specific grounds for revocation in this case, and reject both.

B. Commensurate-in-Scope Test

Respondent demanded that "[a]ny negotiated resolution of federal tax concerns must also address such matters as investment policy, [and] procedures for ensuring that appropriate resources are actually expended on charitable activities . . . ."[126] The respondent essentially charges that KSBE operates a (poorly managed) large investment program with a small school on the side.

As described above, the subset of section 501(c)(3) organizations classified as private foundations operates under a specific statutory obligation to pay out at least 5% of the net value of its investment assets for charitable purposes

---

[125] The first petitions to contest asserted section 4958 tax were filed in the Tax Court in July, September, and November 1999 by six Mississippi home health-care organizations (three nonprofit agencies and their three for-profit successors) and the five family members who control them. The intermediate sanctions in these cases reportedly total $240 million, and the IRS retroactively revoked the exemption of the nonprofit organizations. Excess benefits allegedly arose from the conversion of the nonprofit organizations to for-profit status following a change in Mississippi law. The family's appraiser assigned a negative value to the businesses, which had been losing money for years, but the IRS contends that each was worth at least $5 million. *See* Jennifer Moore & Grant Williams, *Big Test for the IRS*, CHRON. PHILANTHROPY, Jan. 13, 2000, at 49; the full text of some of these petitions and bibliographic information on the others is available electronically under entity names starting with "Sta-Home Health" and the family name "Caracci" in LEXIS, Fedtax Library, PETEXT File.

[126] IRS Letter to Special Purpose Trustees, dated May 4, 1999, *supra* note 98 (concluding paragraph).

each year. No such statutory payout obligation applies to public charities, including schools. In theory, in the absence of a private-benefit purpose, under federal tax law an entity organized and to be operated as a school could accumulate all of its investment income for expenditure at a later date.

Moreover, an organization may still qualify for exemption under section 501(c)(3) "although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the *primary purpose* of carrying on an unrelated trade or business." Sec. 1.501(c)(3)-1(e)(1), Income Tax Regs. (emphasis added).[127] This requirement has become known as the "primary purpose" test.[128] The distinction between purposes and activities led the Service to pronounce the "commensurate in scope" requirement: Revenue Ruling 64-182, 1964-1 (Part 1) C.B. 186, held that a charitable corporation deriving its income principally from the rental of space in a large commercial office building, and making grants to other charities, is entitled to retain its exemption where it is shown to be carrying on through such contributions and grants a charitable program commensurate in scope with its financial resources.[129]

---

[127] Income from an unrelated trade or business would be taxable. *See* sec. 511 *et seq.* Of course, if the organization were a private foundation, it would be subject to the excess business holding limits of section 4943, as described in note 104, *supra.*

[128] Thus, an entity operated for the primary purpose of benefiting private interests is not entitled to exemption. *See, e.g.*, Redlands Surgical Servs., Inc. v. Commissioner, 113 T.C. No. 3 (1999); Housing Pioneers, Inc. v. Commissioner, 58 F.3d 401 (9th Cir. 1995); American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989); B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978); Church by Mail, Inc. v. Commissioner, 765 F.2d 1387 (9th Cir. 1985); Plumstead Theatre Soc'y, Inc. v. Commissioner, 675 F.2d 244 (9th Cir. 1982); est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), *aff'd without published opinion*, 647 F.2d 170 (9th Cir. 1981); Goldsboro Art League, Inc. v. Commissioner, 75 T.C. 337 (1980); Aid to Artisans, Inc. v. Commissioner, 71 T.C. 202 (1978); Harding Hosp., Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974).

[129] A 1971 IRS General Counsel Memorandum explained that the primary purpose test rejects objective tests such as "a comparison of the relative physical size and extent of organizational activities devoted to business endeavors and to charitable endeavors in which the ends to which the beneficial use of an organization's resources are applied . . . ." Gen. Couns. Mem. 34,682 (Nov. 17, 1971). Focusing on purpose, under Code section 502 an organization operated for the primary purpose of carrying on a trade or business cannot claim exemption even if all its profits are turned over to a charity; however, the definition of "trade or business" for this purpose does not include renting real estate, the activity covered in Rev. Rul. 64-182. Separate from the section 502 rules on "feeder organizations," an otherwise exempt charity must pay tax on its unrelated business taxable income. *See, e.g.*, Tech. Adv. Memo. 96-36-001 (Jan. 4, 1996)(ruling that a school conducting substantial publishing activities retains its section 501(c)(3) exemption because it conducts charitable activities commensurate in scope with its resources, but it must pay UBIT on the publishing profits).

Even as it adopted a commensurate-in-scope requirement, the Internal Revenue Service showed little stomach for applying it aggressively.[130] Indeed, Revenue Ruling 64-182, the ruling that first enunciated the test, was taxpayer-favorable. "The fact is," explained a 1971 memorandum written by the IRS Chief Counsel's Office, "the devotion of charity property to business use to produce income in the administration of charity properties can be perfectly compatible with and fully in furtherance of exclusively charitable purpose in the administration of such properties."[131] Indeed, the memorandum continued by discussing the *obligation* of charity managers to make investment assets productive.

Nor have recent years seen an aggressive application of the commensurate test.[132] Indeed, in 1999, the Service released an undated "Field Service

---

[130] *See* Gen. Couns. Mem. 34,682, *supra* note 129: "In the years past, the Service sought by ruling and by litigation to deny the right of charities to engage in business, insisting that somewhere, somehow in the enactment of the exemption provisions Congress must have intended to limit the classification of exempt charities to those charities not engaging to any substantial extent in commercial endeavors." Footnote 3 to this statement cites to Kenneth C. Eliasberg, *Charity and Commerce: Section 501(c)(3)—How Much Business Activity?*, 21 TAX L. REV. 53 (1965), which details the Service's unsuccessful litigation history on this issue.

[131] Gen. Couns. Mem. 34,682, *supra* note 129. Subsequent internal memos describe how the commensurate-in-scope test has been used primarily to support the recognition of exempt status under section 501(c)(3) for organizations that exist solely for the purpose of distributing income to other section 501(c)(3) organizations. *See, e.g.*, Field Service Advisory 1999-10-007 (dated Nov. 24, 1998; release date Mar. 12, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 49-89 (Mar. 15, 1999)(ruling that organization that earns and distributes the net proceeds from the operation of annual sports tournaments to other section 501(c)(3) charities is entitled to exemption).

[132] For a recent discussion of the commensurate-in-scope test, see Paul Streckfus, *Interview with Marc Owens*, 1 EO TAX J. 23, 25-26 (Apr. 1996), in which reporter Streckfus engaged in the following exchange with the director of the IRS's Exempt Organizations Division on February 29, 1996:

> *Streckfus*: . . . A reporter recently asked me about the commensurate test in regards to the Bishop Estate because the reporter pointed out that the estate has a relatively small school and tremendous assets.
>
> *Owens*: There are a number of universities that fall into that category.
>
> *Streckfus*: Well, let's go after them, too, if they're just sitting on the endowment. . . . Is there any life left in the commensurate test, derived from that 1964 revenue ruling, or have you all pretty much given up in applying a commensurate test in any of these instances?
>
> *Owens*: Well, Paul, I've just explained that you have to go through a very intensive factual analysis when you see an organization that has a mix of activities to try and glean from the facts about the nature of the entity. . . . [W]e have that analysis occurring in a lot of cases. We may not always use the word "commensurate" to describe the analysis, but it basically is there. It is what happens any time the IRS analyzes an organization frankly. You look to see what its goals and activities are, what its purposes are, and whether those are charitable or not, and that involves a weighing when you have some mixture.

Memorandum" that calls into question the Service's confidence in the commensurate test as an independent requirement for exemption.[133] While a field service memorandum provides no precedential guidance, the discussion it contains is instructive. In this memorandum, the office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations) answered several questions posed by an unidentified district counsel, who wanted to apply the commensurate test to a claimed educational organization engaged primarily in conducting bingo games. The district office proposed revoking the exemption on the "sole basis" that "the organization could not be said to be carrying on a charitable program commensurate in scope with its financial resources."[134] The district office conceded that neither private inurement nor private benefit existed. The Field Service Memorandum focused on this concession:

> This raises a concern because it is our opinion that indications of private benefit are the most effective means of denying section 501(c)(3) exemptions to troublesome fundraising organizations whose claim to exempt status is the raising of money for charity through the conduct of events such as bingo. The [Technical Advice Memorandum issued by the Exempt Organizations Technical Division] concludes that it does not appear that the bingo activity was initiated by the organization for any other purpose than to raise funds for a charitable program. This statement acknowledges that the organization's principal activity had an exclusively charitable purpose, and would appear that the organization is described in section 501(c)(3) unless it runs afoul of other section 501(c)(3) restrictions.[135]

As of June 30, 1996, the Estate's accumulated income exceeded $288 million.[136] Surpluses are not, however, only a recent phenomenon. A 1926

> *Streckfus*: Have you all taken action against an organization recently based on the commensurate test analysis? Something we haven't seen because it would be an exemption issue.
>
> *Owens*: We certainly have challenged exempt status based on the inherent nature of the activities. I don't know if the word commensurate was involved or not. As you know, we don't review all adverse actions here [in the National Office].

[133] *See* FSA 1999-530, *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 15-105 (Jan. 25, 1999).

[134] *Id.*

[135] In light of "significant litigating hazards" in relying solely on the commensurate test, the Assistant Chief Counsel's office suggested that "[i]t may be appropriate for the Service to compromise and restore exemption if the organization agrees to distribute the existing fund to established section 501(c)(3) organizations that are unaffiliated with officers of the organization within a reasonable period of time, and agrees to distribute net profits currently for charitable purposes." *Id.*

[136] Master's First Supplemental Report on the 109th, 110th, and 111th Annual Accounts of the Trustees, In re *Estate of Bishop*, Equity No. 2048, at VII.D (Haw. Prob. Ct. Sept. 29, 1998), *available in* <http://starbulletin.com/98/09/29/news/masters3.html>.

opinion of the Hawaii Supreme Court found that the "present gross annual income of the estate is approximately $450,000, and the annual expenditures amount to about $408,000, and upon the expiration of old leases and the obtaining of higher rentals under new leases the trustees expect that the income of the estate will gradually increase . . . ." *Smith v. Lymer*, 29 Haw. 169, 171 (1926). In that case, the trustees obtained approval to construct replacement school buildings out of corpus. In a 1943 case, the Estate filed a statement showing over $2 million of accumulated income, of which it wanted to treat nearly $1 million as spent on new school buildings, and the issue was whether the trustees properly used accumulated surplus income as well as corpus. *Collins v. Hodgson*, 36 Haw. 334, 335-36 (1943). Holding that the testatrix intended only corpus to be spent on construction, while "a portion of each year's income" would be used to support and educate orphans and others in indigent circumstances, the court observed that "[t]he testatrix apparently did not anticipate that there would be surplus income." *Id.* at 339. In dicta, the court commented: "The fact that more than one million dollars of income has accumulated makes it apparent that the expressed intention of the testatrix has not been complied with." *Id.* Noting that the record does not disclose "facts from which it could be determined whether or not a continual increase in the surplus income is or may become inevitable," the court suggested that its decision "is not to be understood as having any reference to the power of the chancellor, on a proper bill and showing, to apply the doctrine of *cy pres* and authorize an inevitable surplus, if any, to be applied to some other use within the purview of that doctrine." *Id.* at 340.

A charity can accumulate income for a variety of exempt purposes, including smoothing of expenditures and saving for future expenditures.[137] Regulators and courts have generally taken a laissez-faire approach to matters of the board's "business" judgment, refraining from second-guessing decisions by charity fiduciaries about how or when to make charitable expenditures.[138] To the extent the KSBE Trustees violated the direction of the settlor, we observe that while accumulation was criticized by the Hawaii Supreme Court in 1943, *Collins v. Hodgson*, *supra* at 339, the State courts exercise ongoing supervision of KSBE; moreover, accumulation is currently the subject of an attorney general complaint. We are not satisfied that Congress has empowered the Internal Revenue Service to act as a plenary regulator to fill any perceived supervisory vacuums left by the administration of State charity laws. There is no requirement in the Code that a public charity expend a certain percentage of its income or assets in the current conduct of its charitable program. We decline to support the Service's imposition of such

---

[137] *See generally*, Brody, *Charitable Endowments*, *supra* note 104.

[138] *See generally id.*

a requirement, mechanical or vague, on a charitable board. Accordingly, so long as the resources are dedicated to a charitable purpose, we leave it up to the discretion of KSBE's trustees, guided by State law, to determine when to make such expenditures.

Conclusion as to Commensurate Test:

We appreciate that the Internal Revenue Service is unhappy with the Bishop Estate's performance in managing its investments and program expenditure level. Indeed, this is an issue that also greatly concerns the Hawaii Attorney General. However, in our opinion, the Service's determination to revoke exemption cannot be sustained on the basis of the commensurate test. If Congress desires to give the Service equitable powers to surcharge fiduciaries of public charities for breaches of the duty of care, and to otherwise direct their activities, Congress may enact a set of excise taxes modeled on those that currently apply to private foundations and their fiduciaries.

On the other hand, to the extent the Trustees' failure to spend income was motivated by their desire to increase future income for the purpose of generating larger fees payable to themselves, the Service would be raising a private inurement issue. Hence, we now turn to that asserted ground for revocation.

C. Private Inurement

The respondent asserts that the compensation paid to the Trustees is so egregious that it amounts to private inurement requiring revocation of KSBE's exemption.

The new section 4958 excess-benefits tax can apply only to the benefited insider and to certain charity managers. No tax applies to the organization. None of the Incumbent Trustees is a party to this case. Nevertheless, we discuss section 4958 here because of the relationship between this new regime and the continuing prohibition in section 501(c)(3) on private inurement.[139] If no violation of section 4958 has taken place, then *a fortiori* no private inurement has taken place. Moreover, even if section 4958 sanctions apply, a footnote in the legislative history suggests that revocation would be inappropriate where, on the whole, the organization continues to merit tax-exemption:

---

[139] Section 53.4958-7 of the proposed regulations states: "(a) *Substantive requirements for exemption still apply.* The excise taxes imposed by section 4958 do not affect the substantive statutory standards for tax exemption under sections 501(c)(3) or (4). Organizations are described in those sections only if no part of their net earnings inure to the benefit of any private shareholder or individual."

> In general, the intermediate sanctions are the sole sanction imposed in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization. In practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only when the organization no longer operates as a charitable organization.

H.R. Rep. No. 104-506, *supra*, at 59 n.15, *reprinted in* 1996 U.S.C.C.A.N. 1182 n.15.

The preamble to the proposed regulations promises that the "IRS intends to exercise its administrative discretion in enforcing the requirements of sections 4958, 501(c)(3) and 501(c)(4) in accordance with the direction given in the legislative history." 63 Fed. Reg. at 41,505. The proposed regulations do not describe the circumstances under which an organization will be able to maintain its exemption in an excess-benefit situation. However, according to the preamble, "guidance issued in conjunction with the issuance of final regulations under section 4958" will include the following factors that the Internal Revenue Service will consider in exercising its administrative discretion to preserve an organization's exemption: "whether the organization has been involved in repeated excess benefit transactions; the size and scope of the excess benefit transaction; whether, after concluding that it has been party to an excess benefit transaction, the organization has implemented safeguards to prevent future recurrences; and whether there was compliance with other [federal and State] applicable laws." *Id.* at 41,488.

No formula applies for determining when compensation is reasonable. A footnote in the section 4958 legislative history declares: "the Committee intends that an individual need not necessarily accept reduced compensation merely because he or she renders services to a tax-exempt, as opposed to a taxable, organization." H.R. Rep. No. 104-506, *supra*, at 56 n.5, *reprinted in* 1996 U.S.C.C.A.N. at 1179 n.5.[140] However, proposed section 53.4958-4(b)(3), Income Tax Regs., echoes a footnote in the legislative history (reportedly added in rebuke of intense lobbying by KSBE): "The fact that a State or local legislative or agency body or court has authorized or approved a particular compensation package paid to a disqualified person is not determinative of the reasonableness of compensation paid for purposes of section 4958 excise taxes." 63 Fed. Reg. at 41,488-89; *see* H. R. Rep. No.

---

[140] Oversight Subcommittee Chairman Pickle once mentioned the possibility of a salary cap, perhaps set at $200,000 to match the salary of the President of the United States. *See* Robert A. Boisture & Milton Cerny, *Treasury Proposes Intermediate Sanctions on Public Charities and Section 501(c)(4) Organizations*, 63 TAX NOTES 353, n.7 (Apr. 18, 1994).

104-506, *supra* at 57 n.7, *reprinted in* 1996 U.S.C.C.A.N. at 1180 n.7 (interestingly, the proposed regulations added "or court" to the list).[141]

Until recently, KSBE had not employed officers; rather the Trustees acted as their own chief executives. This structure does not neatly fit a safe harbor in the legislative history and in the proposed regulations (see proposed section 53.4958-6(d), Income Tax Regs.); the typical nonprofit corporate structure separates the directors, who make the compensation decision, from the officers receiving the compensation.

As a separate matter, compensation measured by a percentage of investment returns paid to those who determine investments could trigger a little-understood provision of section 4958: Private inurement can result from a "revenue-sharing" transaction between the charity and the insider, even if the amount of compensation is fair to the charity. Because in such a situation there might be *no* unreasonable amount, the statute provides that where this definition applies, the penalty tax will apply to the entire amount of the revenue sharing. This rule is to apply only to the extent provided in regulations. *See* sec. 4958(c)(2). The proposed regulations carrying out this provision have been strongly criticized. After all, if a charity is permitted to pay reasonable compensation for services, what is wrong with paying incentive compensation where appropriate?[142] Indeed, the facts-and-circumstances test in proposed section 53.4958-5, Income Tax Regs., provides:

> A revenue-sharing transaction may constitute an excess benefit transaction regardless of whether the economic benefit provided to the disqualified person exceeds the fair market value of the consideration provided in return if, at any

---

[141] As a separate matter, the Hawaii attorney general accuses KSBE of expending "over $900,000 of Trust assets to lobby the United States Congress against passage of the Intermediate Sanctions provision and then, when it was clear that the measure would pass, to seek modifications in the legislative history beneficial to the Trustees." Petition for Removal and Surcharge, *supra* note 48 (Count 3, "The Trustees Have Enriched Themselves at the Expense of the Beneficiaries by Accepting Excessive Compensation from the Trust and by Expending Trust Assets to Preserve Their Excessive Compensation: Preserving Excessive Compensation—Self-interested Lobbying," second paragraph). The attorney general also charges that the Trustees "lobbied, advertised, and testified extensively" against any change to the Hawaiian fee schedule for charity trustees. *Id.* (Count 3, same subsection, third paragraph). The attorney general asserts that this amount "was spent entirely for the benefit of the Trustees and to protect their excessive compensation and not at all for the interests of the Beneficiaries or the Trust purpose of educating Hawaiian children." *Id.* (Count 3, same subsection, fourth paragraph). Other charitable organizations opposed the intermediate sanctions proposals as not being in the best interests of sound charity administration. In any event, the tax consequences of the KSBE lobbying expenditures can be left to the section 4958 case against the Incumbent Trustees; we are not prepared to uphold revocation on this ground alone.

[142] *See* Jones, *supra* note 110 (describing situations in which incentive compensation makes economic sense for nonprofit organizations).

> point, it permits a disqualified person to receive additional compensation without providing proportional benefits that contribute to the organization's accomplishment of its exempt purpose.

63 Fed. Reg. at 41,503. The first example in this proposed regulation approves of a compensation arrangement in which a charity investment manager is paid a percentage of any increase in the asset value, because the charity benefits in proportion to the manager. *See* proposed sec. 53.4958-5(D), Example 1, Income Tax Regs.

With the availability of intermediate sanctions to correct prior excess benefits, the refusal of the Incumbent Trustees to step down would not by itself be grounds for the IRS to revoke KSBE's exemption. However, refusal could indicate that something else is amiss—perhaps that wrongdoing insiders are remaining in power, and continuing to violate prohibitions against private inurement. Indeed, the IRS's May 1999 revocation threat appeared to be based on a concern akin to jeopardy assessments: that swift action is needed because otherwise assets might slip out from under their jurisdiction.[143] The Interim Trustees subsequently charged that the Incumbent Trustees had considered moving the Bishop Estate out of Hawaii and reforming it in the Cheyenne River Sioux Reservation in South Dakota.[144] However, this alleged activity took place in 1995, and there is no suggestion that such a move, as alarming as it might sound, could take place without probate court approval.

Moreover, the Service's insistence on the heads of all Incumbent Trustees suggests that the Service has failed to judge each Trustee's situation on its individual merits. We can understand that the Service is unhappy with a highly politicized trustee selection process, and that the Service is unhappy with the unheard-of levels of compensation paid. However, it appears that trustee Oswald Stender acted in the best interests of KSBE. Stender opposed the decision of the other trustees to terminate the community outreach

---

[143] As set out in note 98 above, the IRS's letter said: "Should we receive indications that such movement [of assets beyond the jurisdiction of the Service] is being contemplated, we will terminate any negotiations that are underway, revoke federal income tax exemption, and otherwise move to protect the interest of the federal government." IRS Letter to Special Purpose Trustees, *supra* note 97 (emphasis omitted).

[144] *See* Interim Trustees' Trial Memorandum, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Dec. 13, 1999) [hereinafter Interim Trustees' Trial Memorandum], at III.B.1 ("The Incumbent Trustee Investigated Moving KSBE's Domicile to Escape Oversight of their Activities By the Hawai'i State Courts, Legislature, and Executive Branch"), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 241-10 (Dec. 16, 1999); Interim Trustees' Proposed Findings of Fact, Conclusions of Law and Order, In re *Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Dec. 13, 1999) [hereinafter Interim Trustees' Proposed Findings of Fact], at ¶¶ 55-63 ("Possible Changes in Domicile and Tax Status"), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 241-11 (Dec. 16, 1999). *See also* Rick Daysog, *Bishop Eyed Move to Dakota*, HONOLULU STAR-BULLETIN, Oct. 12, 1999, at A-1.

programs "which reduced the number of Hawaiians served by KSBE from approximately 30,000 in 1992 to 3,200 in 1996 and caused a substantial layoff in the KSBE workforce, resulting in community anger and anxiety on the part of the remaining workforce . . . ."[145] Stender's urging that the management of the Kamehameha Schools be returned from trustee Lindsey to the president and staff was ignored by the board.[146] Stender, joined by trustee Gerard Jervis, filed suit to oust Lindsey before the attorney general showed interest in KSBE's governance matters.[147] Stender cooperated with the Hawaii attorney general's investigation.[148] Stender and Jervis petitioned the probate court to appoint Special Purpose Trustees to deal on the KSBE's behalf in the tax matters. Stender, like the true mother in the story of Solomon's judgment, volunteered to step aside temporarily to prevent loss of KSBE's tax exemption.[149] Even after his interim resignation, Stender proposed that KSBE establish a voucher system for Native Hawaiian students; praising the proposal, an editorial in the *Honolulu Star-Bulletin* commented: "Stender was a courageous dissident on the old board of trustees. His campaign against mismanagement and improprieties by the board led to the [temporary] ouster of the other four members."[150]

---

[145] Miller & Chevalier Letter, *supra* note 25, at 11, 13 (summarizing June 10, 1999 findings of probate Judge Weil in her removal of Trustee Lindsey).

[146] *See id.* at 6 (again referring to Judge Weil's findings).

[147] *See also* Debra Barayuga, *Trustees' Attorney Fees to Be Repaid*, HONOLULU STAR-BULLETIN, Aug. 14, 1999, at A-1 (reporting that the Probate Court has approved the bid by Oswald Stender and Gerard Jervis for reimbursement from the Estate for "reasonable" legal fees and other expenses incurred in suit to remove trustee Lokelani Lindsey; the deputy attorney general said the State was pleased with the ruling).

[148] *See* Daysog, *supra* note 7 (quoting Deputy Attorney General John Anderson as saying: "Stender could have done a lot more, but we don't feel like there will be a tremendous amount of harm if he is not removed.").

[149] Notably, Judge Chang's temporary removal order stated:

> The Court further finds and concludes, with the exception of Trustee Stender, under the strict fiduciary standard applicable to the Incumbent Trustees, that the inaction and indifference of the other Incumbent Trustees to the potential loss of the opportunity to engage in bona fide and meaningful settlement negotiations with the IRS in a special consolidated procedure which is advantageous to the Trust Estate and the potential loss of the Trust Estate's tax-exempt status might thereby result because of their refusal to offer their resignations as Trustees of the Trust Estate constitutes a breach of duty. Simply put, with the exception of Trustee Stender, the other Incumbent Trustees are not acting in the interests of the welfare, protection and preservation of the Trust Estate.

Removal Order, *supra* note 2 (near end of "Negotiations With The IRS"); *see also id.* ("CEO Management Based System")("The Court notes that trustees Stender and Jervis were in favor of a CEO based management system," but the majority trustees violated KSBE's stipulation with the Attorney General and the Special Master to establish this structure).

[150] *Stender's Proposals*, HONOLULU STAR-BULLETIN, Aug. 30, 1999 (editorial), at A-10.

Today, both Hawaii law and the Internal Revenue Code limit compensation to charitable trustees to a "reasonable" amount. To the extent Stender received excess benefits, he, along with the other Trustees, can be made to restore the amounts to KSBE. (We note that Stender offered to limit his 1999 compensation to $621,393 in order to address the IRS's concerns.)[151] Probate court proceedings as to a reasonable level of compensation for KSBE trustees are ongoing.

Conclusion as to Private Inurement:

Given that section 4958 addresses only fiduciary misbehavior involving self-dealing and excess financial benefit, it is our opinion that Congress did not intend to grant the Internal Revenue Service broad powers to require restitution and other remedies for breaches of the duty of care. That is, by enacting the intermediate sanctions that it did—and no more, despite calls to do so—Congress did not mean for the IRS to become a super-State attorney general, with removal powers, nor did Congress mean for the Tax Court, the District Court of the District of Columbia, and the Claims Court to become super-probate courts.[152] Moreover, concurrent federal and State jurisdiction runs the risk of inconsistent governance directives. Recall that the 1977 Treasury proposal to invest federal courts with equity powers over charity

---

[151] *See* Daysog, *supra* note 5.

[152] *See* I.R.C. § 7428 (declaratory judgment actions). *Cf.* United Cancer Council v. Commissioner, 165 F.3d 1173 (7th Cir. 1999)(reversing the Tax Court's finding of private inurement in a "one-sided" fund-raising contract). Judge Posner, writing for the court, complained:

> The Service and the Tax Court are using "control" in a special sense not used elsewhere, so far as we can determine, in the law, including federal tax law. It is a sense which . . . threatens to unsettle the charitable sector by empowering the IRS to yank a charity's tax exemption simply because the Service thinks the charity's contract with its major fundraiser too one-sided in favor of the fundraiser, even though the charity has not been found to have violated any duty of faithful and careful management that the law of nonprofit corporations may have laid upon it. . . .
>
> We were not reassured when the government's lawyer, in response to a question from the bench as to what standard he was advocating to guide decision in this area, said that it was the "facts and circumstances" of each case. That is no standard at all, and makes the tax status of charitable organizations and their donors a matter of the whim of the IRS.

Id. at 1178-79; *see also* Frances R. Hill, *Deregulating the Exempt Sector? CA-7 Reverses Tax Court in United Cancer Council*, J. TAX'N, May 1999, at 303. Professor Hill comments:

> The Seventh Circuit's opinion is a call for deregulation of aspects of exempt organizations' operations. At the same time, its remand on private benefit suggests that some aspects of exempt organizations' operations require continued regulatory scrutiny based on tax law. It is this sophisticated consideration of the role of competing market and regulatory frameworks that makes the Seventh Circuit opinion one of the more important opinions on exempt organizations in recent years.

fiduciaries would have stayed federal proceedings until the conclusion of State enforcement actions.

KSBE is a public charity, with significant charitable assets, operating a significant charitable program. Its trustee fee structure, investment practices, and operations have been under the supervision of the Hawaii probate courts and annual special master review for decades. The fact that the attorney general has initiated an enforcement action and that the special master has sought governance and operational reforms suggests that the State system is working. If the test for entitlement for exemption—despite section 4958 excess-benefit violations—is "would this entity be granted recognition under section 501(c)(3) on a going forward basis?", the answer clearly is yes.

Based on the foregoing discussion, we conclude that this is not a case where the continued operation of KSBE, as supervised by the Hawaii attorney general and the probate courts, would be inconsistent with its federal tax exemption. Contrary to the suggestion of the dissent, we are not holding that the Service can never revoke KSBE's exemption on grounds of inurement, but rather that such an action would, in light of current State proceedings, be premature. We of course draw no conclusions as to the application of Code section 4958 to the individual Incumbent Trustees.

Decision for petitioner.

Reviewed by the Court.

BROWN, SIERRA, MUELLER, DARTMOUTH, PEPPERDINE, AMORY, JACKSON, SCHAUMBERG, and WALZ, JJ., join in this Opinion for the Court.

WALZ, J., concurring.

I whole-heartedly endorse the decision of the Court. Let me also congratulate the courage of the petitioner's Incumbent Trustees for standing up to the respondent. The Interim Trustees assert that loss of tax-exempt status could cost KSBE in excess of $900 million.[153] In many cases, loss of exemption entails taxation on income, loss of deductibility for donations, loss of tax-exemption on the interest paid on the entity's section 501(c)(3) bonds, and possible collateral State tax consequences including loss of property-tax exemption. Given the high stakes, one might expect all but the most impoverished of charities to capitulate to any demands made under threat of revocation. The public knows of only a handful of closing agreements, yet the IRS finalized 78 closing agreements with section 501(c) organizations in fiscal year 1999, 72 in fiscal year 1998, and 65 in fiscal year 1997.[154] The

[153] Interim Trustees' Proposed Findings of Fact, *supra* note 144, at ¶ 91 (citing to October 6, 1999, expert report by Diane Cornwell of Arthur Andersen LLP, contained in Attachment C thereto).

[154] *See* JOINT COMM. ON TAX'N, *supra* note 31, at 38, n.97 (citing the IRS Exempt

respondent's approach to the administration of tax-exempt charities, no matter how commendable its motivation, should not be allowed to proceed without appropriate judicial scrutiny.[155] Someone has to stop the blackmail.

BROWN, J., concurring.

I write only to respond to the assertion raised by the dissent that we should ignore legislative history in this case. Whatever the merits of legislative history generally, the contrast between the section 4958 legislative history and that of another statute emphasizes the validity of the Court's approach. In 1987, Congress added section 4955, which imposes an excise taxes on public charities that engage in political activities.[156] This is so even though section 501(c)(3) contains an absolute prohibition on political campaign activity. Thus, the obvious question arises under section 4955: Is this an intermediate sanction scheme which, like section 4958, renders revocation necessary only

---

Organization Return Inventory and Classification System). In fiscal year 1999, the IRS revoked the exempt status of 97 organizations, of which 20 were exempt under section 501(c)(3); in fiscal year 1998, the IRS revoked the exemption of 97 organizations, 38 described in section 501(c)(3); and in fiscal year 1997, the IRS revoked the exemption of 89 organizations, 38 described in section 501(c)(3). *Id.* at 27 n.56 (citing the IRS Audit Information Management System, Tables 41 and 42).

[155] Even the threat of revocation disrupts charity operations. As KSBE's counsel Miller & Chevalier warned their client before litigation commenced:

> [S]uch litigation would impose a significant financial burden on the Estate, involving at least several million dollars in legal fees and other expenses. Moreover, the time period between the Service's revocation of KSBE's tax-exempt status and the rendering of a judicial opinion concerning KSBE's continuing qualification as a 501(c)(3) organization would be lengthy, potentially more than three years. The threat of revocation would create financial uncertainty in the Estate's operations during these years, thereby possibly precluding the Estate from engaging in meaningful strategic planning for educational programs, or implementing expansion plans, until litigation is resolved and the amount of the liability resulting therefrom (including a substantial tax bill if revocation is sustained) is resolved.

Miller & Chevalier Letter, *supra* note 25, at 21.

[156] The organization might also be subject to tax under section 527(b) on political organization taxable income. *See also* secs. 501(h) & 4911 (excise tax on excess lobbying expenditures by electing public charities). Unlike its absolute prohibition against political campaign activity, section 501(c)(3) allows public charities to lobby so long as this activity is not a "substantial part" of its activities. In 1976, to provide some certainty to charities, Congress created an election for certain public charities to lobby within dollar and percentage limitations, with excise taxes imposed on charities that exceed the limits and "with revocation of exempt status reserved as a sanction for those organizations that exceed the limits by a significant amount over a period of several years." *Testimony of Assistant Treasury Secretary for Tax Policy Roger J. Mentz before the House Ways and Means Subcommittee on Oversight* (Mar. 12, 1987), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 87 TNT 49-6 (Mar. 13, 1987) [hereinafter *Testimony of Assistant Treasury Secretary for Tax Policy*].

in egregious cases, or is the excise tax collectible on top of revocation of exemption?

The conference committee report to the Revenue Act of 1987 explains that section 4955 was prompted by the dual concerns that revocation could equally be disproportionate to inadvertent actions and be ineffectual in cases of significant violations:

> As the Congress concluded in adopting the two-tier foundation excise tax structure in 1969, the Internal Revenue Service may hesitate to revoke the exempt status of a charitable organization for engaging in political campaign activities in circumstances where that penalty may seem disproportionate— i.e., where the expenditure was unintentional and involved only a small amount and where the organization subsequently had adopted procedures to assure that similar expenditures would not be made in the future, particularly where the managers responsible for the prohibited expenditure are no longer associated with the organization. At the same time, where an organization claiming status as a charity engages in significant, uncorrected violations of the prohibition on political campaign activities, revocation of exempt status may be ineffective as a penalty or as a deterrent, particularly if the organization ceases operations after it has diverted all its assets to improper purposes.

H.R. Rep. No. 100-391, at 1623-24 (1987), *reprinted in* 1987 U.S.C.C.A.N. 2313-1, 2313-1204. However, the report emphasizes:

> The adoption of the excise tax sanction does not modify the present-law rule that an organization does not qualify for tax-exempt status as a charitable organization, and is not eligible to receive tax-deductible contributions, unless the organization does not participate in, or intervene in, any political campaign on behalf of or in opposition to any candidate for public office (secs. 501(c)(3), 170(c)(2)).

Id. at 1624; *see also id.* at 1626 (same).

This statement in effect rebuffs an earlier suggestion made by the Treasury Department that the excise taxes on public charities engaged in political activities should operate "in lieu of automatic revocation of exempt status." The Assistant Secretary for Tax Policy had proposed that "the organization should be subject to loss of its exempt status" only "[a]bsent correction of the expenditure, or in cases of repeated or flagrant violations."[157]

The IRS evidences some understandable contortions in the administration of this purported absolute ban on political activity. On the one hand, section 53.4955-1(a), Income Tax Regs., reiterates the legislative history that "[t]he excise taxes imposed by section 4955 do not affect the substantive standards for tax exemption under section 501(c)(3), under which an organization is described in section 501(c)(3) only if it does not participate or intervene in

---

[157] *Testimony of Assistant Treasury Secretary for Tax Policy, supra* note 156.

any political campaign on behalf of any candidate for public office." However, the IRS's Continuing Professional Education program for its exempt-organizations technical staff espouses an interest in a flexible approach to enforcement, with taxes in some cases operating as an intermediate sanction.[158]

As a policy matter, Congress could rationally have concluded that the political activity prohibition should be absolute while inurement violations should be subject only to taxes on the wrongdoers in appropriate cases. After all, "correction" in the case of inurement can remedy mere financial harm done to the charity, whereas prohibited campaign activity cannot be so easily undone. Accordingly, the closing agreements with Jerry Falwell's Old Time Gospel Hour, Jimmy Swaggart Ministries, and Pat Robertson's Christian Broadcasting Network not only required the payment of taxes, but also required the organizations to make changes in corporate governance and to publicize the general terms of the closing agreements.[159] However, I share the

---

[158] See also the comments of Marcus Owens, director of the Exempt Organizations Division:

> [W]e are not interested in creating a safe harbor at a particular level of campaign intervention for charities . . . If the charity does have an ongoing program of truly charitable activity and recognizes that an error was committed and takes appropriate steps to insure that it won't happen again, we would take those factors into consideration in fashioning a resolution of the case.

Transcript of A.B.A. Tax Section Mini-Program: Political Activities of Exempt Organizations, PACs, and IRC Section 527: An Overview of IRS and Federal Election Commission Rules, Held on May 8, 1993, in Washington, D.C., 8 EXEMPT ORG. TAX REV. 267, 277 (Aug. 1993).

[159] *See Public Statement, Jimmy Swaggart Ministries, Baton Rouge, Louisiana* (Dec. 17, 1991), 5 EXEMPT ORG. TAX REV. 205 (Feb. 1992). In this agreement, the organization agreed to desist from political activities—Jimmy Swaggart Ministries had endorsed Pat Robertson's presidential bid—and to pay about $170,000 in back taxes and interest. According to the public statement: "Under the terms of a closing agreement between itself and the IRS, JSM has made certain changes in its organizational structure, including the creation of an 'Audit and Compliance Committee' composed of members of an expanded board of trustees, to ensure that no further political campaign intervention activities will occur." *Id.* at 207; *see also Statement of Jerry Falwell Regarding Closing Agreement* (Feb. 17, 1993), 7 EXEMPT ORG. TAX REV. 876 (May 1993), describing the agreement by the Old Time Gospel Hour to a two-year revocation of exemption and the payment of $50,000 in tax for political activity. According to Reverend Falwell's statement: "The IRS agrees that the organizational changes made by OTGH are satisfactory to preclude future political activity and has reinstated tax-exempt status for years after 1987." *Id.*; *see also News Release, The Christian Broadcasting Network* (Mar. 16, 1998), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 98 TNT 55-78 (Mar. 23, 1998), describing the terms of the agreement, including:

> the loss of CBN's tax exemption for 1986 and 1987 due to the application of the rules prohibiting intervention in political campaign activities . . .; a significant payment by CBN to the IRS . . . ; an increase in the number of outside directors on CBN's board; and other organizational and operational modifications to ensure ongoing compliance with the tax laws.

Id. Practitioner Gregory L. Colvin complained about the lack of specificity in the CBN news

uneasiness of some of my fellow judges with the use of closing agreements: Not only did these organizations release statements rather than the closing agreements themselves, but the bases for the penalties and taxes were not spelled out, leaving the charitable sector with an abiding sense of lack of accountability in the Service.[160] (KSBE's Closing Agreement includes an unallocated amount of the total $9 million payment for section 4955 taxes, as well requires publication of the Closing Agreement.) While we might commend the agency for endeavoring to preserve exemptions, in enacting the section 4958 intermediate-sanction regime, Congress evidently decided not to leave such an important matter up to agency discretion.

BUCK, J., dissenting.

I would uphold respondent's determination. As a threshold matter, I am baffled by the majority's ruling that the disposition of this important issue turns on a single footnote of legislative history. As Justice Scalia has often observed, Congress enacts laws, not committee reports. *See, e.g., Conroy v. Aniskoff*, 507 U.S. 511, 518-529, 123 L. Ed. 2d 229, 113 S. Ct. 1562 (1993)(Scalia, J., concurring in judgment); *United States v. Thompson/Center Arms Co.*, 504 U.S. 505, 521 (1992)(Scalia, J., concurring in judgment); *Blanchard v. Bergeron*, 489 U.S. 87, 98-100, (1989)(Scalia, J., concurring in part and concurring in judgment). If Congress so clearly wanted revocation to be a sanction of last resort, it could have said so in section 4958, not just in a footnote to a committee report.

More substantively, I am alarmed by the majority's view that the administration of the federal tax-exemption scheme is, essentially, preempted by State law. To the contrary, the Internal Revenue Service has been and must be free to enforce the requirements of the Code independently of the

---

release:

> In the Jimmy Swaggart case we learned something about the IRS's view about how the statements of an individual can be attributed to the organization[.] . . . But here, . . . [t]here is nothing of concrete substance to let us know how the IRS is interpreting the law, except that it is interpreting it strongly and with definitive consequences for the organization.

Fred Stokeld, *Christian Broadcasting Network, IRS Reach Settlement*, 78 TAX NOTES 1596 (March 30, 1998)(internal quotation marks omitted).

[160] *See* Tax Analysts v. Internal Rev. Serv., 53 F. Supp. 2d 449, 452 (D.D.C. 1999)(holding that exempt organization closing agreements are not subject to the public disclosure requirements of section 6104, and that section 6103 bars their disclosure because closing agreements constitute "return information" by containing "determinations of the existence . . . of liability."); Tax Analysts v. Internal Rev. Serv., Civ. No. 98-2345 (TPJ) (D.D.C. Aug. 6, 1999), *available in* LEXIS, Fedtax Library, Tax Notes Today File, *as* 1999 TNT 152-78 (Aug. 9, 1999)(denying release of closing agreement between IRS and Christian Broadcasting Network).

operations of State nonprofit laws. The respondent cannot be expected to defer to the pace, resources, and judgment of 50 State attorneys general. This case illustrates how the threat of exemption and nothing less can get the attention of the State courts. Moreover, there might never be a State proceeding that leads to governance reforms, particularly since the IRS is barred by law from disclosing its investigations to the State until final determination of revocation of exemption—and revocations are so rare. In sum, the American taxpayer should not be expected to support charities that lack basic fiduciary discipline.

If ever a case invokes the ultimate sanction of loss of exemption, the continuing tenure of these Incumbent Trustees does. The Court's narrow construction of the issues in this case fails to acknowledge that much more than excess compensation—highly excess compensation, I may add—appears in the record. The hubris of the Incumbent Trustees has so distorted their perception that they simply forgot why they were placed in such an important position of trust. What charity trustees spend hundreds of thousands of dollars paying lawyers to seek ways to evade regulatory oversight, to the point where they considered giving up tax-exempt status altogether, at a potential cost of $900 million?[161] Evidently, only the quirk that the Bishop Estate was a charitable trust rather than a nonprofit corporation averted such a flight from regulation, since probate court approval would not have been required for a corporate change in domicile.[162] Moreover, the Incumbent Trustees expended over $800,000 in legal fees during 1995 and 1996 to lobby against the intermediate sanctions legislation, including the failed effort to have the "state law" footnote removed from the legislative history.[163] Additionally, trust assets were expended for political activities, and at least one Incumbent Trustee reportedly lobbied to defeat the reconfirmation of the attorney general, the Incumbent Trustees' nemesis.[164] Finally, the record includes cases of co-investing and other improprieties by Incumbent Trustees and their affiliates, matters that in some cases have inspired criminal investigations.[165] This litany makes the neglect of prudent investing and educational purpose seem almost

---

[161] *See* Interim Trustees' Proposed Findings of Fact, *supra* note 144, at ¶ 63 (citing testimony that KSBE spent almost $300,000 in evaluating a possible change in domicile and tax status). As the expert report of Professor John Langbein stated: "Prudent trustees do not spend trust funds to explore ways of harming their beneficiaries." Interim Trustees' Trial Memorandum, *supra* note 144, at III.B.1 & n.8 (quoting Expert Report of John Langbein, Oct. 6, 1999, Attachment D to the Interim Trustees' Proposed Findings of Fact, *supra* note 144).

[162] Former attorney general Bronster commented recently that the interests of her office and of the IRS were not perfectly aligned. As an example, she observed that the federal tax agency showed no concern over the state of domicile. *EO Committee Meeting*, *supra* note 36.

[163] *See* Interim Trustees' Proposed Findings of Fact, *supra* note 144, at ¶¶ 64-72.

[164] *Id.* at ¶¶ 76-80.

[165] *See* note 26, *supra*.

a benign sideshow. Nevertheless, the Incumbent Trustees flaunted State court authority by ignoring probate court orders to terminate the lead-trustee governance system and to institute a CEO-based management system; to clarify Estate financial records; to adopt a plan for spending accumulated income; and to waive commissions on final distributions of capital.[166]

Given the strong federal interest in making sure that charitable organizations operate within the confines of law, I see no compelling reason why Congress's failure to enact a broad "equity" power in the IRS should be seen as a refutation of the IRS's ability to extract whatever concessions it deems appropriate in the closing agreement process. In the absence of Congressional direction to the contrary, I would not handcuff the agency to the extent the Court suggests.

Moreover, the IRS did not exercise impermissible equity powers; its warning was not a threat, but a courtesy. Effectively, the IRS said: "We cannot permit this charity to keep its tax-exempt status with these people at the helm—the pattern of abuse is simply too great. Nevertheless, to avoid punishing the beneficiaries, before revoking exemption and sending a tax bill, we'll announce our intentions to allow the appropriate court to remove the trustees (or let them resign)."[167] Should this not be how the Service negotiates a closing agreement?

In this case, the respondent determined that the Incumbent Trustees engaged in a pattern of activity so consistently adverse to the interests of KSBE that, on a going-forward basis, KSBE could not be considered to be operating as a charitable organization. Indeed, by concluding a (provisional) closing agreement before the permanent removal of the Incumbent Trustees, the respondent has exercised admirable deference to the State law proceedings.

Finally, this Court does not address the broader administrative concern: If we restrict the IRS's powers with respect to closing agreements in the section 501 area, what, if anything, does this do with respect to IRS powers in other closing agreement situations? In the business setting, closing agreements can often specify in detail acceptable transfer pricing methods which in essence would dictate a change in internal business practices.[168] It appears that the "new" IRS will focus even more on education and settlement under the general rubric of "voluntary compliance." Before propounding a restriction on IRS powers in closing agreements in the section 501 area, this Court should make certain that the exempt-organization regime is sufficiently distinguishable enough from other areas of tax enforcement that we avoid creating a bad precedent for tax administration generally. The complexity of

---

[166] Interim Trustees' Proposed Findings of Fact, *supra* note 144, at ¶¶ 92-96.

[167] I am grateful to Professor Randall Roth for this formulation.

[168] I thank Professor John Colombo for this observation.

the issues can be illustrated by a recent legislative provision to preserve the confidentiality of advance pricing agreements; perhaps we should also leave it to Congress to decide whether exempt-organization closing agreements should be kept confidential in all cases, which would facilitate settlements, but at the cost of public education.[169]

HERNANDEZ, OPPEWAL, BULLOCK, DAVIS, JONES, DE COSTA, GRANT, and SIBLEY, JJ., join in this dissenting opinion.

---

[169] See sections 6103(b)(C) and 6110(b), as amended by section 521 of The Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, 113 Stat. 1860 (1999) (treating advance pricing agreements as confidential taxpayer information). Note that the Joint Committee has recently recommended that exempt-organization closing agreements be made public (and without redaction), but makes no disclosure recommendation with respect to closing agreements not involving tax-exempt organizations. *See* JOINT COMM. ON TAX'N, *supra* note 31, at 85 n.186.