
A COMPARISON OF TAX EXEMPT ORGANIZATIONS IN THE PEOPLE'S REPUBLIC OF CHINA AND THE UNITED STATES

Stephanie Hoffer[†]

*The charities that soothe and heal and bless
are scattered at the feet of man like flowers.*

William Wordsworth, *The Excursion*¹

I. Introduction

Throughout recorded history, man has relied upon the good works of his fellow man to support those left behind by the collective endeavor.² As a result, charitable organizations hold a special place in society. Because they find strength in the number of their members, charitable organizations have “the energy, the vision, the drive, the tenacity,” that individual philanthropists and reformers may not possess.³ They have proved themselves agents of change at home and abroad.⁴

As such, charitable organizations have been unwelcome in countries with non-democratic forms of government.⁵ The People's Republic of China is one such country. The Cultural Revolution eliminated nearly all of the country's charitable institutions for a period of over twelve years, ending in 1978.⁶ Afterward, the Chinese government established a handful of closely controlled nongovernmental organizations to facilitate the receipt of international aid and cooperation.⁷ Over the past ten years, these and other Chinese organizations have undergone signifi-

[†] Stephanie Hoffer received her L.L.M. from New York University School of Law and will join the Northwestern University School of Law as a visitor in 2006. She would like to thank Eran Lempert for his helpful comments on this piece.

¹ WILLIAM WORDSWORTH, *THE EXCURSION* (Liver Pool Univ. Pr. 2004) (1814).

² For instance, Leviticus 23:22, thought to be written in the 6th century B.C., provides that “[w]hen you reap the harvest of your land . . . you shall not pick your vineyard bare, nor gather up the grapes that have fallen. These things you shall leave for the poor and the alien.”

³ LOWELL W. LIVEZEY, *NONGOVERNMENTAL ORGANIZATIONS AND THE IDEAS OF HUMAN RIGHTS* 19 (1998).

⁴ *Id.* at 28 (citing Puritans, Quakers, and abolitionist societies as “modern organizations of political dissent” that acted “for explicitly egalitarian and revolutionary change”); *see also* REPORT TO CONGRESS AND THE NONPROFIT SECTOR ON GOVERNANCE, TRANSPARENCY, AND ACCOUNTABILITY 10 (2005), *available at* <http://www.NonprofitPanel.org> (follow “final report” hyperlink; then follow “final report” hyperlink) (last visited Oct. 22, 2005) [hereinafter PANEL ON THE NON-PROFIT SECTOR] (describing the rapid expansion of the nonprofit sector in the colonial and revolutionary periods, as noted by Alexis de Toqueville in 1831, as differentiating the United States from Europe and noting the sector's development into integral community institutions such as libraries, local schools and 911 services).

⁵ *See generally* LIVEZEY, *supra* note 3, at 19-34.

⁶ Deng Guosheng, *NGO's Come of Age*, *BEIJING REVIEW*, Apr. 1, 2004, at 28.

⁷ *Id.*

Comparison of Tax Exempt Organizations

cant changes in functional purpose and governance, moving in lockstep with China's transformation to a limited market economy.⁸

In the United States, by contrast, activities of volunteer organizations first appeared in the form of services provided by religious societies.⁹ With the growth of a strong market economy, these services gave rise "to the 'market failure' theory of volunteer organizations, to the view that voluntary organizations have their *raison d'être* in the failure of the market to meet the needs that they are established to meet."¹⁰ Some scholars within the United States also view voluntary organizations as mediators between individuals and the mass society.¹¹ "As 'mediating structures' they both give the individual access to institutions in order to claim the society's benefits more effectively, and provide space for individuals to retreat from society, better to fulfill the values and experience the customs that are not shared by society at large."¹² It is difficult to overstate the prevalence in the United States of groups tailored to serve these purposes. In 2003, the Internal Revenue Service ("IRS") master file contained information on 1.6 million tax-exempt organizations.¹³ In fiscal year 2000, these organizations held over two trillion dollars in assets and reported over nine hundred billion dollars in revenues.¹⁴

Both the United States and China are on the cusp of major changes in governmental regulation of charitable organizations. As China moves forward with the marketization of its socialist economy, the use of nonprofit organizations for both mediation and alleviation of market failure has become increasingly important. Toward that end, China's State Council has enacted a law describing the role and governance of charitable foundations in China. The United States, on the other hand, has a fully developed charitable law, but it is one that the government has considered amending to discourage instances of fraud and self-dealing that have recently come to light.¹⁵ This article seeks to compare and contrast the two systems with an eye toward informing the work of scholars and policy-makers interested in the governance of charitable organizations.

⁸ *See id.*

⁹ LIVEZEY, *supra* note 3, at 29-30.

¹⁰ *Id.*

¹¹ *Id.* at 33.

¹² *Id.*

¹³ STAFF OF JOINT COMMITTEE ON TAXATION, DESCRIPTION OF PRESENT LAW RELATING TO CHARITABLE AND OTHER EXEMPT ORG. AND STATISTICAL INFO. REGARDING GROWTH AND OVERSIGHT OF THE TAX-EXEMPT SECTOR, JCX-44-04, at 1 (June 22, 2004) [hereinafter JOINT COMMITTEE ON TAXATION].

¹⁴ *See id.*

¹⁵ *See* Sen. Max Baucus, *Baucus Calls Behavior of Some Charities "Unacceptable,"* TAX NOTES TODAY 121-42 (June 23, 2004) [hereinafter *Baucus Remarks*].

Comparison of Tax Exempt Organizations

II. Recent History in Charitable China

A. The Social Backdrop

China's recent history has been one of upheaval and of phenomenal growth. After the economic standstill of the Cultural Revolution in the late 1960's and 1970's, reform policies adopted by Deng Xiaoping in the early 1980's quadrupled the Chinese per capita gross domestic product by the year 2000.¹⁶ As part of its reform, China's government created nongovernmental organizations to interact with international interests and to spur investment in the country.¹⁷ Less than a decade after its military action on Tiananmen Square, which seemingly quashed the possibility of individual pursuits, the country began a government-controlled transition to a market economy.¹⁸ The country's rapid economic growth created "astounding disparities in the distribution of wealth, placing China today among the most unequal nations in the world."¹⁹ Consequently, these events have "rendered the current Chinese social and political environment sensitive, unstable and potentially explosive. Social tensions are now created not only from aspirations for greater individual and political freedom . . . but increasingly from the unequal distribution of wealth and power."²⁰

At least one commentator has noted that this unequal distribution is the result of inefficiencies in China's newly established market economy. He notes:

Even if a competitive market might generate a Pareto-efficient allocation of resources, there are still the cases for government action, because an efficient allocation of resources might entail great inequality. . . . The problem is to decide which Pareto-efficient allocation conforms to society's notion of distributive justice. Obviously, the market cannot do it. The social welfare function is simply not a market construct; it must evolve from the political process.²¹

The Chinese government, through recent enactment of meaningful charitable organization reform, has taken one step toward this elusive distributive justice. In doing so, it has implicitly bent to its citizens' demands for both greater freedom and for a greater stake in the country's wealth. Beginning in the late 1990's, reform of government-sponsored charitable organizations began to give way to

¹⁶ XUDONG ZHANG, *WHITHER CHINA? INTELLECTUAL POLITICS OF CONTEMPORARY CHINA* 9 (Xudong Zhang ed., 2001).

¹⁷ Despite their name, the government closely controlled these groups. See Guosheng, *supra* note 6.

¹⁸ See ZHANG, *supra* note 16.

¹⁹ *Id.* at 11. The author adds,

The polarization between China's richest and poorest regions is considered by economists in China and worldwide to be not only worse than that of the United States, one of the most unequal of all advanced capitalist countries, but also on par with such oligarchic or crony-capitalist countries such as Russia or Indonesia.

²⁰ *Id.* at 12.

²¹ Shaoguang Wang, *THE CHANGING ROLE OF GOVERNMENT IN CHINA* 5 (Feb. 8, 2000), http://www.cuhk.edu.hk/gpa/wang_files/UNDP.pdf (last visited Oct. 23, 2005).

Comparison of Tax Exempt Organizations

the establishment of truly independent ones.²² While government-sponsored organizations had confined their operation to fields in harmony with the socialist ideal, such as women's rights and environmental protection, independent charities broadened their scope to include migrants, Acquired Immunodeficiency Syndrome ("AIDS"), and legal assistance to the poor.²³ Nonetheless, these organizations, while permitted to exist, did not have the imprimatur of the Chinese government.²⁴ As a result they sometimes suffered from "a lack of public prestige."²⁵ In fact, fewer than 100,000, or one percent, of China's 10 million registered companies have records of charitable donations to such charities.²⁶

B. The Portent of SARS

Special regulations, adopted in May 2003, paved the way for the introduction of substantial changes to public participation in the China's charitable foundations.²⁷ The regulations provided that products, diagnosis, treatment, quarantine equipment, and vehicles donated by foreign sources for use in the fight against Severe Acute Respiratory Syndrome ("SARS") could pass to the China Charity Foundation and the Red Cross Society of China free of import, customs, Value Added Tax ("VAT"), and consumption taxes.²⁸ In addition, the State Taxation Administration announced that companies in China could deduct one hundred percent of the value of cash and materials donated to combat SARS.²⁹ Generally, Chinese law limits corporate income tax deductions for charitable contributions to ten percent of a company's income.³⁰ The SARS measure was a significant departure from past practices, and it foreshadowed an even greater change to come.

C. Enactment of the Regulation on Foundation Administration

China's current Regulation on Foundation Administration took effect on June 1, 2004.³¹ It was adopted to effectuate three much-needed policy goals: to encourage the organization and activities of foundations; to maintain the legal rights and interests of foundations, donors, and beneficiaries; and to promote

²² See Guosheng, *supra* note 6.

²³ See *id.*

²⁴ See *id.*

²⁵ *Id.*

²⁶ See Chen Chao, *China's Charities and Philanthropists*, CHINA INTERNET INFO. CENTER, Apr. 27, 2004, <http://www.china.org.cn/english/2004/Apr/94150.htm> (last visited Oct. 22, 2005).

²⁷ See CIRCULAR OF THE MINISTRY OF FINANCE ON EXEMPTING THE IMPORT TAXES FOR DONATED MATERIALS FOR PROPHYLAXIS AND TREATMENT OF CONTAGIOUS ATYPICAL PNEUMONIA (promulgated by the Ministry of Finance May 2, 2003, effective May 2, 2003), *available at* LEXIS PRCLEG 2778.

²⁸ See *id.*

²⁹ Chao, *supra* note 26.

³⁰ See AUDITING CRITERIA (People's Republic of China), art. 79.

³¹ REGULATION ON FOUNDATION ADMINISTRATION, (promulgated by the State Council of China, Mar. 8, 2004, effective June, 1, 2004), *available at* LEXIS PRCLEG 3463.

Comparison of Tax Exempt Organizations

public participation in the country's welfare undertaking.³² As with most of its market reform policies, the Chinese government has not completely loosened its grip. All foundations must "abide by the Constitution, laws, statutes, regulations and the state policy, and shall not endanger the national security, unity, and national solidarity, and shall not breach social morality."³³ Nonetheless, this law represents a turning point in China's relationship with charitable organizations. Although its subjective restriction on activities against solidarity and morality open the door for government intervention should the experiment fail, the Regulation ushers in a new period of respectability for nonprofit organizations that are not affiliated with the government.

III. Regulatory Regimes: Comparing Chinese and United States Laws

Although starkly different in many ways, the United States and Chinese governments share in common the governance of vast and economically potent nations. Both are shepherd market economies, one long established and the other a promising fledgling. Both are called to fight for the individuals that national progress leaves behind. Charitable organizations are an important part of these struggles. China has a decades-long history of seeking social parity for its people but is inexperienced in governing a market of free actors. On the other hand, the United States has over two centuries' experience in governing a market of free actors but has never, as a nation, sought complete social equality for its people. This dichotomy of experience and increasing unity of economic structure has produced two systems of charitable governance whose similarities and differences speak to the similarities and differences of their countries of origin.

A. Organizational Classes

Both China and the United States regulate charitable organizations through use of a classification system. Under China's Regulation on Foundation Administration (the "Regulation") "foundation" refers to a nonprofit organization that uses donated property in pursuance of welfare undertakings.³⁴ These organizations are divided into two classes. Public offering foundations solicit contributions from the general public, and non-public offering foundations are not permitted to do so.³⁵ Public offering foundations are further divided into national public offering foundations, whose mission and solicitation is national in scope, and regional public offering foundations, whose operation and solicitation is limited to the state in which the foundation is organized.³⁶ The tax consequences to donors

³² *Id.* art. 1.

³³ *Id.* art. 4. The theme of this subjective catch-all prohibition on anti-State activities is repeated in a separate regulation, which provides that the name of a foundation must not harm state or public interest, mislead the public, connote superstition, or contain foreign letters or the name of a foreign country; *see* PROVISIONS ON THE ADMINISTRATION OF NAMES OF FOUNDATIONS, (promulgated by The Ministry of Civil Affairs, June 23, 2004, effective June 7, 2004), *available at* LEXIS PRCLEG 3569.

³⁴ REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, art. 2.

³⁵ *Id.* art. 3.

³⁶ *Id.*

Comparison of Tax Exempt Organizations

do not appear dependent on the organization's classification, although methods of governance differ for public and nonpublic foundations.³⁷

In contrast, the Internal Revenue Code of the United States (the "Code") names no fewer than twenty-nine individually numbered categories of tax-exempt organizations, most of which serve a public policy goal.³⁸ These organizations run the gamut—the catalogue includes everything from instrumentalities of Congress to social and recreational clubs.³⁹ Tax treatment and regulation of an organization and its donors depends upon the organization's numerical classification.⁴⁰ The numerical classification system allows the United States government to tailor legislation to a particular category of organization.⁴¹ This versatile component of United States law is an important feature of the Code because the needs and possible pitfalls of organizations may vary according to their purpose, but it also adds a level of complexity in governance that is not present in the Chinese Regulation.

B. Description of Charitable Purpose

Both China and the United States require tax-exempt organizations to serve a specified purpose. Due to the complexity of United States tax exemption law, this article will focus on organizations described by section 501(c)(3) of the Code. These organizations are "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals. . . ."⁴² This organizational description, of the twenty-nine enumerated descriptions provided by the Code, appears similar to the Chinese criterion that foundations "participate in a welfare undertaking."⁴³ Although the Chinese Regulation lacks the detail of the United States provision and does not elaborate on the meaning of "welfare undertaking," purposes of some organizations discussed in English-language articles released around the effective date of the Regulation are similar to those governed by section 501(c)(3) of the Code, with the absence of promotion of religion.⁴⁴ It is

³⁷ See generally *id.*

³⁸ See 26 U.S.C. §501(c)(3), (d) (2005).

³⁹ See *id.*

⁴⁰ See, e.g., 26 U.S.C. §§170, 501, 505 & 511 (2005).

⁴¹ See, e.g., 26 U.S.C. §505 (2005) (establishing anti-discrimination rules for employee benefit organizations).

⁴² 26 U.S.C. §501(c)(3) (2004).

⁴³ REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, art. 1.

⁴⁴ For instance, Great New Wall for Impoverished University Students provides college scholarships for rural students. See Tang Yuankai, *The More You Give, The More You Get*, BEIJING REV. June 17, 2004 at 28 (June 2004), available at <http://www.bjreview.com.cn/ml-zhong/ml-200424-z.htm> (last visited Oct. 23, 2005). The Shanghai Education Development Foundation shares a similar mission; see Chao, *supra* note 26. Others include Friends of Nature, The China Youth Development Foundation, China Foundation for Poverty Alleviation and the Green Volunteer Association of Chongqing, which "successfully aroused public concern about forest protection in Sichuan Province, through a TV program on China Central Television." See also Guosheng, *supra* note 6. It must be noted, however, that the promotion of religion is significantly absent from China's accepted "welfare activities."

Comparison of Tax Exempt Organizations

worth noting that the standard set forth in the Regulation is subjective and therefore open to interpretation by taxpayers and the government.

C. Incorporation and Federal Recognition Processes

Organizations hoping to benefit from the regulatory framework established for charities in the United States and in China generally must satisfy several bureaucratic requirements before they begin operation. In the United States, organizations are formed under state law but must also apply for federal recognition of tax-exempt status if they anticipate receiving annual incomes in excess of \$5,000.⁴⁵ As a result, organizations are subject to regulation by both federal and state governments. The federal government monitors tax exempt status, and the state governments monitor corporate organization and fiduciary use of funds.⁴⁶

The Chinese process also embodies national and local components. Although the entire incorporation and exemption process is a function of national law, it is carried out at the provincial level.⁴⁷ The process differs somewhat from that of the United States because China does not have independent state governments.⁴⁸ As a result, the national government has a constant hand in governing all aspects of charitable compliance, and for that reason, it has a potential organizational advantage over the United States in matters of charitable oversight.

A recent proposal of the Senate Finance Committee (the “Committee”) suggests the United States may move to eliminate this discrepancy by assigning federal prosecutorial power to the states in exchange for assumption of traditional state business oversight powers.⁴⁹ Under the proposal, “[s]tates would be provided the authority to pursue certain Federal tax law violations by exempt organizations with approval of the IRS.”⁵⁰ In addition, the proposal would impose federal best corporate practices on charities.⁵¹ This is an area traditionally reserved to state governance, and the proposal, if adopted, would be a significant affront to federalist principals. Under it, the Code would go so far as to prescribe

⁴⁵ JOINT COMMITTEE ON TAXATION, *supra* note 13, at 11; IRS, 2004 Form 1023 Instructions at 2, <http://www.irs.gov/pub/irs-pdf/i1023.pdf> (last visited Oct. 23, 2005) [hereinafter IRS Form 1023 Instructions].

⁴⁶ See PANEL ON THE NON-PROFIT SECTOR, *supra* note 4, at 13.

⁴⁷ See REGULATION OF FOUNDATION ADMINISTRATION, *supra* note 31, arts. 9-19 (public offering foundation established through application to provincial business supervisory authority and administrative department of registration).

⁴⁸ See OWEN D. NEE ET. AL., BUSINESS OPERATIONS IN THE PEOPLE’S REPUBLIC OF CHINA, 957-2nd T.M.I(B) (2004).

⁴⁹ See SENATE FINANCE COMMITTEE, TAX EXEMPT GOVERNANCE PROPOSALS: STAFF DISCUSSION DRAFT 7 (June 22, 2004), available at <http://www.finance.senate.gov/sitepages/2004HearingF.htm/hearings2004.htm> (follow “Tax Exempt Governance Proposals: Staff Discussion Draft” hyperlink) [hereinafter SENATE FINANCE COMMITTEE DISCUSSION DRAFT] (last visited Oct. 23, 2005); see also PANEL ON THE NONPROFIT SECTOR, *supra* note 4, at 4. (recommending creation of a federally funded program to help states increase oversight and education and urging elimination of statutory barriers to information sharing between the IRS and the states).

⁵⁰ SENATE FINANCE COMMITTEE DISCUSSION DRAFT, *supra* note 49, at 7.

⁵¹ See *id.* at 11-15.

Comparison of Tax Exempt Organizations

the number of directors a charity might have.⁵² This is strikingly similar to the Chinese law.⁵³ In addition, the proposal would grant the IRS power to remove board members, officers, or employees of a charity who violate “self-dealing rules, conflicts of interest, excess benefit transaction rules, private inurement rules, or charitable solicitation laws.”⁵⁴ Charitable solicitation laws traditionally have been state laws.⁵⁵ The federal government’s assumption of solicitation monitoring would further blur the line between state and federal enforcement of charitable law and bring the United States system of charity creation and governance into agreement with the Chinese system. This is a surprising result given that China’s government is national while the United States government is federal.

D. Tax Benefits to Donors

China and the United States both impose limits on the amount of charitable contributions that individuals and corporations may deduct for income tax purposes. These limitations reveal something of each nation’s political culture. In China, limitations are based on the recipient.⁵⁶ Corporations and individuals are entitled to unlimited dollar for dollar (or, more appropriately, Yuan for Yuan) deductions for their contributions made for the purpose of national defense or troop support;⁵⁷ however, deductions for contributions to charitable organizations are limited to ten percent of income for corporations and twenty percent of income for individuals.⁵⁸

Conversely, the United States draws no distinction among charitable recipients based on national defense. Contributions to organizations described in section 501(c)(3) of the Code are equally deductible regardless of the charitable purpose those organizations serve.⁵⁹ Instead, the main limitation imposed on donors within the United States stems from their income.⁶⁰ An individual donor generally may not claim charitable deductions in excess of fifty percent of income, and a corporate donor may not claim charitable deductions in excess of ten percent of income.⁶¹ In addition, deductions for the nation’s wealthiest individual donors are further reduced by an amount that is equal to the lesser of three percent of the taxpayer’s adjusted gross income or eighty percent of the taxpayer’s otherwise

⁵² *Id.* at 13.

⁵³ See REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, art. 20.

⁵⁴ SENATE FINANCE COMMITTEE DISCUSSION DRAFT, *supra* note 49, at 13-14.

⁵⁵ See Multi-State Filer Project, STANDARDIZED REGISTRATION FOR NONPROFIT ORGANIZATIONS (2004), <http://www.multistatefiling.org/index.html> for an example of the Unified Registration Statement, which is submitted to states and requires detailed information on an organization’s solicitation activities.

⁵⁶ See REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, art. 27.

⁵⁷ See AUDITING CRITERIA (People’s Republic of China), art. 79.

⁵⁸ See AUDITING CRITERIA (China), art. 79; INCOME TAX LAW (China), art. 17.

⁵⁹ See generally 26 U.S.C. §170 (2005).

⁶⁰ See 26 U.S.C. §170(b) (2005).

⁶¹ See *id.* Note that in some instances, donors’ deductions are limited to 30% or 20% of their adjusted gross income.

Comparison of Tax Exempt Organizations

allowable itemized deductions.⁶² The Chinese law does not yet impose similar restrictions.⁶³

E. The Private Foundation Difference

Unlike their Chinese counterparts, tax deductions available to United States donors may be further limited to twenty or thirty percent of the donor's income if the donee is a "private foundation" that does not meet certain requirements.⁶⁴ A private foundation is one that receives a substantial portion of its funding from a single source or a few sources.⁶⁵ Organizations with this funding structure are more susceptible to tax abuse than those that are funded by the general public.⁶⁶ As a result, they must abide by stricter rules than those applicable to publicly-funded charities.⁶⁷ These rules include restrictions on dealings between the foundation, its substantial contributors and its managers, annual distribution requirements, rules against holding substantial equity positions in companies, rules against investments that jeopardize the foundation's charitable purpose, and stricter requirements regarding permissible donees.⁶⁸

Like the United States, China has established separate systems of governance for private and public foundations.⁶⁹ Many provisions of the Regulation approximate those of United States private foundation law; however, some provisions which would only apply to private foundations in the United States apply to both private and public foundations in China.⁷⁰ In essence, the Chinese system subjects all charities, and not just those with limited sources of funding, to stricter rules of governance than those that apply to United States publicly funded charities.

F. Restrictions on Conduct of Charities

Despite their comparative flexibility, basic restrictions applicable to United States charities are easily characterized and clearly defined. Four universal rules apply to all United States charities described in section 501(c)(3) of the Code.

⁶² 26 U.S.C. §68(a) (2004). In 2005, the §68 limitation only applied to individuals whose adjusted gross income exceeds \$145,950. Rev. Proc. 2004-71, 2004-50 I.R.B. 970. This limitation will be gradually reduced over a five-year period beginning in 2005 and completely eliminated in 2010 per §68(f), however, the limitation will return full force in 2011 unless Congress acts to counter the sunset provision contained in §901 of Public Law No. 107-16.

⁶³ See generally REGULATION ON FOUNDATION ADMINISTRATION *supra* note 31.

⁶⁴ 26 U.S.C. §170(b)(1)(E) (2005).

⁶⁵ 26 U.S.C. §509 (2004).

⁶⁶ See TURNEY P. BERRY, PRIVATE FOUNDATIONS—SELF-DEALING (Section 4941), 879-2nd T.M. I(A) (2004) (stating "the provisions of Chapter 42 of the Internal Revenue Code, enacted by the Tax Reform Act of 1969, were intended to curb certain perceived abuses involving private charitable foundations.").

⁶⁷ See *id.*

⁶⁸ See 26 U.S.C. §§4940-45 (2005).

⁶⁹ See generally REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31.

⁷⁰ *Id.*

Comparison of Tax Exempt Organizations

First, a charity must be operated exclusively for a public purpose.⁷¹ Next, none of a charity's net earnings may inure to the benefit of any individual who is not a charitable beneficiary.⁷² This generally means that a charity may not provide excessive compensation for goods and services, and upon dissolution of a charitable organization, its assets must be transferred to another charity.⁷³ Third, "no substantial part" of the charity's activities can be the "carrying on of propaganda" or attempting to influence legislation, and the organization may not campaign on behalf of political candidates.⁷⁴ Finally, the organization must not conduct activities that violate public policy.⁷⁵ Whether an activity violates public policy is judged by reference to the laws and pronouncements of the executive, legislative, and judicial branches of the government.⁷⁶

China's law does not contain counterparts to these United States provisions, although they may be inferred from some parts of the Regulation. For instance, a foundation is required to engage in welfare activities according to its charter, and the foundation's charter must not "specify contents that are beneficial to a special natural person, legal person, or other organization."⁷⁷ Taken together, these provisions may have similar substantive effects as the United States' ban on private inurement and its requirement of operation exclusively for a public purpose. Nonetheless, those rules are not explicit in the Regulation, and it is unclear whether a charitable organization in China might be permitted latitude to perform those activities disallowed to United States organizations.

Stricter rules apply in other areas. The Regulation contains many generally applicable operating provisions that affect only private foundations under the Code. First, foundations in China are required to make prudent and productive investments of donated funds.⁷⁸ This rule is reminiscent of the jeopardizing investment restriction applicable to private foundations in the United States, which imposes a five percent tax on certain investments that are inconsistent with the organization's charitable purpose.⁷⁹ Next, the Regulation requires a public offer-

⁷¹ 26 U.S.C. §501(c)(3) (2005).

⁷² *Id.*

⁷³ *See generally* Church of Scientology of Cal. v. Comm'r, 823 F.2d 1310 (1987) (church which transferred over two million dollars directly to church founder, who controlled all of church's funds, was not exempt under section 501(c)(3) of the Code because its actions resulted in private inurement); IRS Form 1023 Instructions, *supra* note 45, at 8-9.

⁷⁴ 26 U.S.C. §501(c)(3) (2005).

⁷⁵ Bob Jones Univ. v. United States, 461 U.S. 574, 591 (1983).

⁷⁶ *See generally id.* at 600-02 (court reviewed legislative, executive, and judicial authority to determine whether the IRS exceeded its authority.).

⁷⁷ REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, arts. 5, 10. Interestingly, this provision seems to ban supporting organizations, which have commonly been employed in the United States to provide monetary support to civic leagues and other charitable organizations; *see* 26 U.S.C. §509(a)(3) (2004) where recent investigation into charitable organizations has revealed that supporting organizations are particularly susceptible to abuse, and recently proposed amendments to United States law have called for their elimination; *see* Senate Finance Committee Discussion Draft, *supra* note 49, at 2.

⁷⁸ *See* REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, arts. 25, 27.

⁷⁹ *See* 26 U.S.C. §4944(1)(a) (2004) (that provides, "[i]f a private foundation invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes, there is hereby imposed on the making of such investment a tax . . .").

Comparison of Tax Exempt Organizations

ing foundation to make welfare expenditures that meet or exceed seventy percent of its income from the prior year.⁸⁰ Non-public offering foundations must make welfare expenditures that meet or exceed eight percent of their prior year's total net asset value.⁸¹ Again, private foundations in the United States are subject to similar minimum expenditure rules. A foundation that fails to make welfare distributions in excess of five percent of the net value of assets not used directly in carrying out the foundation's exempt purpose is subject to a fifteen percent excise tax on the undistributed amount.⁸²

The Regulation diverges from the Code on the subject of administrative expenses. It provides that "[t]he wages and welfare of the staff of a foundation and the expenses of administration shall not exceed 10% of the total expenditure of the current year."⁸³ In contrast, the United States places no limit on administrative expenses.⁸⁴ Instead, "reasonable and necessary" administrative costs are considered part of the foundation's charitable giving.⁸⁵ Although a limitation was briefly imposed in the United States, an IRS study published in 1990 found that most foundations' charitable expenditures far exceeded their administrative ones.⁸⁶ Congress never renewed the limitation; however, recent investigations into the activities of charitable organizations have spurred a new proposed limitation.⁸⁷ The new limitation would apply only to private foundations and would call for an automatic IRS investigation of administrative expenses in excess of ten percent of the foundation's total expenses.⁸⁸ Any expenses above thirty-five percent of the foundation's total expenses would be considered *per se* unreasonable.⁸⁹ It is worth noting for comparison purposes that if the proposed limitation were passed, both the United States and China would use ten percent as the benchmark of acceptable charitable administration cost.

G. Related Person Restrictions

China's rules on related persons in foundation management are more restrictive than the corresponding United States provisions.⁹⁰ In China, foundations are required to have boards of directors composed of five to twenty-five individu-

⁸⁰ REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, art. 29.

⁸¹ *Id.*

⁸² See 26 U.S.C. §4942 (2004).

⁸³ REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, art. 29.

⁸⁴ Section 4942(g)(4) of the Code used to limit the amount of administrative expenses counted as nontaxable "qualifying distributions." This limitation expired in 1990. See 26 U.S.C. §4942(g)(4)(F) (2004).

⁸⁵ 26 U.S.C. §4942(g)(1)(A) (2004).

⁸⁶ See THOMAS J. SCHENKELBERG, ESQ. AND VIRGINIA C. GROSS, PRIVATE FOUNDATIONS – DISTRIBUTIONS (§4942), 880 2nd TMP III(J)(2) (2004), citing IRS Grant-Making Administrative Expenses Study (Jan. 27, 1990).

⁸⁷ See SENATE FINANCE COMMITTEE DISCUSSION DRAFT, *supra* note 49, at 5.

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ See REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, ch. III.

Comparison of Tax Exempt Organizations

als.⁹¹ Only one third of the directors may receive compensation for their services.⁹² In non-public offering foundations that are created with private funds, “[I]f some of the directors thereof are close relatives, the total number thereof shall not exceed one third of the total number of directors. The directors of other foundations who are close relatives shall not hold a post concurrently [on the board of directors].”⁹³ In addition, an interested director (meaning one whose affairs outside of the foundation will be affected by the board’s decision on a particular matter) is not permitted to participate in decisions related to the relevant interest.⁹⁴ Finally, directors and supervisors of the foundation, and the close relatives of those individuals, are flatly forbidden to engage in transactions with the foundation they serve.⁹⁵

These restrictions on related persons are similar in nature to disqualified person rules applicable to private foundations found in the Code. Although there is no prohibition against relatives serving as co-directors of private foundations, “self-dealing” transactions with “disqualified persons” are heavily taxed.⁹⁶ Disqualified persons include a substantial contributor to the foundation, officers and directors of the foundation, a relative of a substantial contributor, officer or director, or finally a business in which a substantial contributor, officer or director owns more than a thirty-five percent stake.⁹⁷ “Self-dealing” transactions include a sale or lease of property, lending or borrowing money, furnishing goods and services, payment of compensation by the foundation, and transfer of foundation property to the disqualified person.⁹⁸

An excise tax may also apply to managers and employees of United States public charities who enter into questionable compensation arrangements.⁹⁹ The tax applies to any “disqualified person” who receives a benefit from a charity in excess of the value of goods or services provided to the charity by that person.¹⁰⁰ The definition of disqualified persons for purposes of the excise tax on public charities is similar to that used for private foundations and generally includes any person who is able to exercise financial control over the organization.¹⁰¹ It also applies to any manager who approved the excess benefit transaction.¹⁰²

The Code contains exceptions to the self-dealing rules for those transactions that benefit the foundation and do not benefit the disqualified person.¹⁰³ In addi-

⁹¹ *Id.* art. 20.

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.* art. 23.

⁹⁵ *Id.*

⁹⁶ *See* 26 U.S.C. §4941 (2004).

⁹⁷ 26 U.S.C. §4946(a)(1) (2004).

⁹⁸ 26 U.S.C. §4941(d)(1) (2004).

⁹⁹ 26 U.S.C. §4958 (2004).

¹⁰⁰ 26 U.S.C. §4958(a)(1) (2005).

¹⁰¹ 26 U.S.C. §4958(f)(1) (2005).

¹⁰² *Compare* 26 U.S.C. §4958(a)(2) with 26 U.S.C. §4946(a)(1).

¹⁰³ *See* 26 U.S.C. §4941(d)(2) (2005).

Comparison of Tax Exempt Organizations

tion, the United States tax regulations permit a private foundation or a public charity to pay a reasonable salary to directors and officers for services rendered in pursuit of the organization's charitable purpose.¹⁰⁴ As a result, governance of related person transactions in the private foundation context is in some ways less restrictive than its Chinese counterpart. China flatly forbids foundation managers from engaging in transactions with the foundations that they serve, while the United States allows all such transactions but subjects those that endanger the integrity of the foundation to a prohibitive excise tax.

Recently proposed amendments to the tax law in the United States would bring its content much closer to that of China's law.¹⁰⁵ In particular, the Committee has suggested that self-dealing rules should apply to all charitable organizations, whether public or private.¹⁰⁶ In addition, the proposal would expand the definition of "disqualified person" to include a corporation or partnership with respect to which an otherwise disqualified person "is a person of substantial influence."¹⁰⁷ The Committee's proposal would flatly forbid compensation of a private foundation's directors, and it would limit compensation of a public charity's directors to "comparable federal government rates for similar work and similar time to support salary."¹⁰⁸ These changes, if put into effect, would make the United States' system of charitable governance quite similar to China's. Both countries would limit the influence and compensation of interested persons in charitable organizations and strongly discourage self-dealing transactions.

H. Annual Reporting and Government Oversight

The Committee's proposal would also draw the United States closer to China in its oversight of charitable activities. Currently, U.S. charities with annual income in excess of \$25,000 are required to file a report with the IRS and must make the report publicly available for inspection.¹⁰⁹ In the absence of an audit, this report serves as the sum total of the federal government's oversight of charitable organizations. States generally follow the same procedure, and most states' laws do not give government agencies the right to participate in foundation activities.

In contrast, China supervises foundations directly.¹¹⁰ Foundations are required to appoint "supervisors" who must attend board meetings and "reflect information to the administrative departments of registration, business supervisory authority, and tax authorities or the accounting department in charge."¹¹¹ In ad-

¹⁰⁴ See Treas. Regs. §53.4941(d)-3(c) (as amended in 1980); Treas. Regs. §53.4958-4 (as amended in 2002).

¹⁰⁵ See generally SENATE FINANCE COMMITTEE DISCUSSION DRAFT, *supra* note 49.

¹⁰⁶ *Id.* at 3-5.

¹⁰⁷ *Id.* at 4.

¹⁰⁸ *Id.* at 5.

¹⁰⁹ See Instructions for Form 990 and Form 990-EZ 1, 8, available at <http://www.irs.gov/pub/irs-pdf/i990-ez.pdf>.

¹¹⁰ See generally REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31.

¹¹¹ *Id.* art. 22.

Comparison of Tax Exempt Organizations

dition, various provincial government offices are directed by statute to annually inspect foundation offices, direct and supervise foundation activities, and review annual reports.¹¹² Furthermore, foundations are required to “accept the tax supervision and the accounting supervision by the competent departments of taxation and the competent accounting departments.”¹¹³ These powers are much broader than those imposed by either federal or state governments in the United States and reflect a strong difference in political culture between the two countries. Finally, illegal acts by a Chinese foundation can result not only in cancellation of the foundation’s existence but also in criminal punishment.¹¹⁴ This provision is no small matter in a country that recently executed four bankers for fraud and embezzlement.¹¹⁵

III. Analysis of Compared Laws

From two extremes of political culture, the United States and China have nearly reached consensus, at least on paper, of the appropriate method of governing charitable organizations. This agreement is hardly surprising, given China’s push for rapid marketization and the United States’ slow drift from a truly federal government toward a national system. The recent vintage of China’s law, in comparison to the long history of relevant the Code sections, suggests that Chinese lawmakers may have something to learn from the relative complexity of the United States system. On the other hand, revelation about the prevalence of fraud among charitable organizations in the United States has produced a proposal from the Committee that would shift United States law strongly in the direction of Chinese-style governance.

A. Recommendations for Revision of the Code Based on a Comparison to the Regulation of the People’s Republic of China

The United States’ governance of charitable organizations is more permissive than China’s governance in several important ways. Charitable institutions in China are required to distribute a minimum percentage of either their income or the value of their assets each year.¹¹⁶ In the United States, only private foundations are subject to a minimum distribution rule, and this rule requires only distribution of a percentage of the value of the charity’s assets not used in furtherance of its exempt purpose rather than a percentage of the value of *all* of the charity’s assets.¹¹⁷ In addition, China requires charities to minimize expenses of administration.¹¹⁸ The United States places no limit on those expenses.¹¹⁹ China also

¹¹² See *id.* arts. 34-36.

¹¹³ *Id.* art. 37.

¹¹⁴ See *id.* arts. 40-45.

¹¹⁵ Jiang Zhuqing, *Financial Crooks Get Tough Penalty*, CHINA DAILY, 2004 WL 89401066 (Sept. 2004).

¹¹⁶ See REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, art. 29.

¹¹⁷ See 26 U.S.C. §4942 (2004).

¹¹⁸ REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, art. 29.

Comparison of Tax Exempt Organizations

flatly forbids all charitable directors from transacting business with the foundations that they serve.¹²⁰ The United States limits these transactions only for private foundations, and only in certain instances.¹²¹ Finally, China takes a more hands-on approach to supervision of charities, employing annual on-site visits and permissive government intervention in charities' operations as a means of oversight.¹²² In contrast, the United States requires only an annual report.¹²³

The results of the United States' hands-off approach to charitable foundations cannot be summarized easily. The nonprofit sector is notably varied and controls vast resources.¹²⁴ It plays a vital role in the social, economic and moral lives of United States citizens.¹²⁵ It seems likely that the country's relaxed method of oversight has contributed to the growth and importance of charitable institutions, which is no doubt a blessing rather than a curse. Nonetheless, the Committee's recent investigation revealed that some charities have paid inflated salaries to executives, participated in insider deals without adequate transparency, engaged in abusive tax shelters, and funneled money to terrorist organizations.¹²⁶ Senator Max Baucus denounced the behavior as "sloppy, unethical and criminal."¹²⁷

Selective adoption of China's stricter methods of governance could improve charitable oversight in the United States. Many of China's proposals are tailored to maximize use of charitable foundations' assets for charitable work, while many of the problems cited by the Committee center on use of those assets for purposes unrelated to charitable work. It is no surprise, then, that the Committee's proposed remedy bears many similarities to China's law. Like China's Regulation, the Committee's proposal would limit administrative expenses, place restrictions on the dealings of foundation directors, and give the IRS greater oversight power.

¹¹⁹ See SCHENKELBERG, *supra* note 86.

¹²⁰ See REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, art. 23.

¹²¹ See 26 U.S.C. §4941 (2004).

¹²² See generally REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31.

¹²³ See Instructions for Form 990 and Form 990-EZ 1, 8, available at <http://www.irs.gov/pub/irs-pdf/990-ez.pdf>.

¹²⁴ See JOINT COMMITTEE ON TAXATION, *supra* note 13.

¹²⁵ Baucus Remarks, *supra* note 15.

¹²⁶ See *id.*; see also Written Statement of Mark W. Everson Commissioner of Internal Revenue Before the Committee on Finance United States Senate Hearing on Exempt Organizations: Enforcement Problems, Accomplishments, and Future Direction 5-14, Apr. 5, 2005, available at <http://finance.senate.gov/hearings/testimony/2005test/metest040505.pdf> (detailing abuses of tax exempt status by charitable organizations).

¹²⁷ Baucus Remarks, *supra* note 15. For example, a committee was recently formed to investigate the Statue of Liberty-Ellis Island Foundation on charges that the foundation had misled donors about its financial condition in order to raise funds and on charges that it paid unjustifiably high salaries to its executives; see Fred Stokeld, *Review Committee Releases Findings on Statue of Liberty Charity; Finance Committee Probe Continues*, 2004 TAX NOTES TODAY 149-3 (Aug. 2, 2004). The executive salary controversy is not isolated—there have been a number of high profile investigations in recent months. For one example, see *Study Finds Some Charities Pay "Astronomical Compensation" Packages*, 2004 TAX NOTES TODAY 163-52 (Aug. 20, 2004) (noting that compensation packages paid to executives of the Greenpeace supporting organization, Greenpeace Fund, "appear to be entirely inappropriate considering the organization performs essentially no work.").

Comparison of Tax Exempt Organizations

Even with those recommendations in place, the Committee's recommendation does not approach the Regulation in terms of simplicity and potential effectiveness. Using the Regulation as an example, the United States should consider enacting simple limits on administrative expenses, directors' salaries, and minimum grant distributions. These measures would not only help good charitable actors who are unsatisfied with the ambiguous state of current law, they would also reduce funds available for malfeasance by boards of directors gone awry. In addition, simple numerical limits would enhance the IRS's enforcement function by making annual charitable foundation reports more meaningful to reviewing agents. Although adopting this recommendation will not solve all of the United States' charitable governance problems, it will ensure that, in the absence of outright fraud, charitable organizations will report instances when their executives' salaries and administrative expenses exceed an acceptable level and when grants for their charitable purposes fall below an acceptable level. This bright-line proposal would seem to be an effective check on even marginally law-abiding boards of directors.

B. Recommendations for Revision of the Regulation Based on a Comparison to Internal Revenue Code

The Code is both more and less detailed than the Regulation. Although it prescribes the many minutiae of incorporation, capitalization, and report filing of charitable foundations, the Regulation fails to anticipate the fine details of taxpayer ingenuity now covered by the Code. Because the United States Congress has spent decades observing and correcting various forms of tax-exempt organization abuse, the Code's anti-abuse provisions, particularly those relating to excess benefit transactions and private foundations, are extraordinarily complex. Although this complexity is an obvious detriment to charitable organizations (and a boon to their attorneys), it serves an important purpose. Without it, United States charitable foundations would be open to personal use rather than exclusively public use. For China, whose forceful reform policy has already encouraged corporate graft and whose citizenry harbors only shallow support for privately run institutions, abuse of tax-exempt organizations will no doubt become a serious matter as use of those organizations becomes more widespread.¹²⁸

The Code differs from the Regulation in several key respects. First, the Code clearly enunciates and categorizes the various purposes of tax-exempt organizations.¹²⁹ This enables Congress to legislate specifically and narrowly to a particular kind of organization when necessary. It also enables the founders and directors of organizations to properly tailor their purposes and activities to those that are sanctioned by the Code. China, in contrast, requires only a "welfare undertaking" that does not jeopardize national security, solidarity, or morality.¹³⁰ In doing so, it loses the legislative ease retained by Congress to target particular

¹²⁸ See ZHANG, *supra* note 16.

¹²⁹ See 26 U.S.C. 501(c) (2004).

¹³⁰ REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, arts. 2, 4.

Comparison of Tax Exempt Organizations

kinds of organizations. In addition, the Regulation's subjective description of charitable purpose makes the government appear less than genuine in its encouragement of independent organizations. The standards of national security, solidarity, and morality would seem to prevent a charitable organization from undertaking any task in contravention of current government thinking.¹³¹ In areas prone to controversy, such as foreign adoption, migration, and ethnic preservation, the Regulation's subjective stance could have a serious chilling effect on charitable activity because it seems to allow the government to eliminate any charity at will.

To avoid inhibiting charitable undertakings, the Chinese government should outline a policy similar to that described by the United States Supreme Court in *Bob Jones University v. United States*.¹³² In that case, the Court looked to all three branches of the government in order to determine whether racial discrimination at an educational institution ran counter to the common-law rule against granting tax-exemption to organizations that, through their actions, violate public policy.¹³³ China, too, should look to existing written expressions of law and policy preference, which could serve as a foothold for charitable organizers and courts in instances of dispute.

Another difference between the Code and the Regulations comes in the area of related person transactions. The Regulation limits the number of "close relatives" who may serve as directors of a private offering foundation.¹³⁴ It also prohibits directors from participating in decisions on matters of personal financial interest to them.¹³⁵ Finally, it prohibits business transactions between directors or their close relatives and the foundation they serve.¹³⁶ These provisions are broader than corresponding provisions of the Code because the Regulation's provisions apply to *all* charities while the Code's provisions apply only to private foundations. Nonetheless, the Code provisions contain an important level of detail that is absent in the Regulation.

The Regulation restricts its concept of a disqualified person to foundation directors and supervisors. The Code, in contrast, looks not only to a charitable organization's management but also to those who may be in a position of influence, for instance, after making substantial contributions to the foundation.¹³⁷ There is no doubt that even in the United States, charities must be responsive to

¹³¹ China's Ministry of Culture has used similar standard to rule by fiat in the past year, requiring Britney Spears to wear less revealing clothing during concerts given in the country and banning as "an insult to national dignity" a Nike television commercial featuring NBA star LeBron James as a character in a kung-fu movie; see *Britney Given Green Light on China Tour*, China Daily, June 1, 2004, at 1, available at http://www.chinadaily.com.cn/english/doc/2004-06/01/content_335591.htm; see *China Bans Nike TV Ad as National Insult*, China Daily, Feb. 12, 2004, at 1, available at http://www.chinadaily.com.cn/english/doc/2004-12/07/content_397920.htm.

¹³² *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983).

¹³³ *Id.* at 600-02.

¹³⁴ See REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, art. 20.

¹³⁵ *Id.* art. 23.

¹³⁶ *Id.*

¹³⁷ See 26 U.S.C. §4946(a)(1) (2004); Treas. Regs. §53.4958-3(c).

Comparison of Tax Exempt Organizations

the wishes of their high-dollar donors. The Code restriction exists to keep this responsiveness within reasonable bounds. The failure of China's law to comprehend the influence of substantial contributors leaves open the possibility of abusive quid pro quo transactions with wealthy taxpayers who are not foundation directors.

In addition to targeting managers and substantial contributors, the Code also prohibits foundations from dealing with businesses that are heavily influenced by the foundation's managers and substantial contributors.¹³⁸ The Regulation seems not to contain any corresponding provision.¹³⁹ This second omission is also important. With China's increasing privatization, the number of wealthy individuals who hold ownership interests in businesses will grow. By not prohibiting transactions between these businesses and charitable foundations directed by related business owners, the Regulation opens the door to an income tax shelter that has been outlawed in the United States by the private foundation regulations. Under the Regulation, a wealthy business owner could create a private offering foundation by donating a sum of money to it. One-third of the directors could be close relatives of the founder, and one third of the directors could draw a salary from the foundation.¹⁴⁰ Under the Regulation, the foundation's investment earnings would not be subject to income tax.¹⁴¹ Furthermore, although the founder and his close relatives would be prohibited from transacting business with the foundation, their corporation would not be subject to a similar prohibition. Although the founder would be somewhat restricted in his dealing with the foundation, he would still have two viable and important avenues of withdrawing his appreciated donation: directors' salaries and transactions with his corporation. Thus, the Regulations should define the term "close relative" to include businesses owned in specific percentages by foundation directors and contributors in order to prevent the shelter described above.

One final and important difference between the Regulation and the Code is the approach of both laws to government oversight. The Regulation currently calls for a very high level of government involvement in the administration of charitable foundations.¹⁴² The Chinese government is required to inspect foundation offices annually, to engage in "routine supervision and administration," to examine the foundation's annual report, and to provide special tax and accounting supervision.¹⁴³ The Code does not call for a similar level of government involvement. Instead, it requires the IRS to review an annual return and to conduct investigation of that return if necessary.¹⁴⁴

¹³⁸ *Id.*

¹³⁹ The term "close relative" is not defined in the Regulation. I have assumed that it refers to family members.

¹⁴⁰ REGULATION ON FOUNDATION ADMINISTRATION, *supra* note 31, art. 20.

¹⁴¹ *See id.*

¹⁴² *See id.* at ch. V.

¹⁴³ *Id.*

¹⁴⁴ 26 U.S.C. §6033 (LEXIS through 2004).

Comparison of Tax Exempt Organizations

Although the United States may be moving toward a more hands-on approach to governing charities, it is unlikely to reach the level required by the Chinese regulation.¹⁴⁵ Even if there were a political will to scrutinize each and every charitable organization in the United States, the IRS simply lacks the resources to do so.¹⁴⁶ In 2003, the IRS was responsible for policing 1.6 million exempt organizations.¹⁴⁷ If China's new Regulation encourages growth of its nonprofit sector on par with that of the United States, its bureaucracy will be overwhelmed.

Both countries should consider adopting a system of oversight that combines elements of both the Code and the Regulation. This hybrid method should employ a meaningful reporting system that would require submission of a foundation's audited financial statements, bank records, and managers' affidavits in order to identify charitable organizations at risk under the law. The governments could then focus their attention on those organizations, employing on-site visits, and special guidance when appropriate. By using a hybrid oversight statute, China could learn from the United States' experience and avoid prevalent misuse of charitable organizations without overwhelming its bureaucratic system. Likewise, the United States could move toward a more effective system of governance.

In summary, there are useful lessons to be learned on both sides. The United States should consider adopting bright-line minimum distribution and maximum administrative expenditure requirements to encourage an appropriate level of grant-making and to provide the IRS with meaningful guidelines for assessment. Such guidelines would allow the IRS to follow China's example and increase on-site oversight where organizations' returns indicate potential problems. China should likewise rely upon organizations' annual reports for guidance as to the appropriate level of on-site oversight in order to avoid overwhelming local bureaucracies as the country's charitable sector expands. In addition, China should adopt a more objective standard of charitable purpose, which would create freedom and promote the establishment of charities tailored to needs of China's people, whether or not the government recognizes those needs. Finally, in order to prevent taxpayer abuse, China should adopt the United States' disqualified person definition, which has been crafted over a long period of time in response to known taxpayer behaviors.

¹⁴⁵ See Evelyn Brody, *Submission in Response to June 2004 Discussion Draft of the Senate Finance Committee Staff Regarding Proposed Reforms Affecting Tax-Exempt Organizations*, 2004 TAX NOTES TODAY 143-92 (July 26, 2004) (suggesting that increased IRS powers and privatization of charitable oversight are not desirable because current laws suffice); Mark Pacella, *Statement of the National Association of State Charity Officials to the United States Senate, Committee on Finance*, 2004 TAX NOTES TODAY 121-37 (June 23, 2004) (supporting increased reporting requirements and information sharing with state regulators); Derek Bok, *Statement to Senate Finance Committee*, 2004 TAX NOTES TODAY 121-36 (June 22, 2004) (urging that "excessive administrative burdens may well outweigh the positive results that a more cautious, incremental approach can achieve").

¹⁴⁶ See Fred Stokfeld, *EO Reps Respond to Finance Draft of Charity Reform Proposals*, 2004 TAX NOTES TODAY 142-1 (July 22, 2004).

¹⁴⁷ See *JCT Describes Current Law on Exempt Organizations*, 2004 TAX NOTES TODAY 121-9 (June 22, 2004).

Comparison of Tax Exempt Organizations

IV. Conclusion

While the United States and China have divergent political cultures, they are both faced with the difficult task of governing large economies. Both have realized that the nonprofit sector plays an important role in such economies, and both have developed comprehensive systems of oversight for charitable organizations. The United States' past experience has provided it with a detailed set of requirements but a hands-off style of enforcement. China, in contrast, has had little experience with preventing taxpayer manipulation in a market economy, so its law is weak in detail but strong on enforcement.

In spite of these differences, the similarity of the two laws, and the strikingly Chinese proposal of the Committee, paint a picture of two countries moving toward the center on issues of charitable governance. The United States has adopted stricter laws, as well as a more national and less federal view of charitable organizations. China has become more permissive, giving its imprimatur to nongovernmental charitable institutions for the first time in over forty years. Both have reached an understanding on the importance of altruism in organized form, and both societies should benefit from their newly-found common ground.