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# Exempt Entities as Government Contractors: Regulation Through Cooperative Federalism

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2013 Columbia Law School Charities Regulation and Oversight Project  
Policy Conference on  
"The Future of State Charities Regulation"

Jurisdictional Boundaries: State/Federal, State/State Relationships

*Exempt Entities as Government Contractors: Regulation Through Cooperative  
Federalism*

*Frances R. Hill\**

*The role of exempt entities as government contractors highlights the complexity of exempt entities' relationships with numerous government regulatory agencies administering diverse bodies of law at both the federal and state levels. Exempt entities' roles as government contractors can be neither understood nor regulated solely, or even primarily, in terms of their tax status. Activities undertaken as government contractors and the way those activities are pursued may be consistent or inconsistent with federal and/or state requirements for exemption from taxation. But, compliance with tax law requirements does not establish compliance with other bodies of law or establish that the entity can provide the expertise required to implement government programs or that its actual operations are consistent with its contractual obligations. A regulatory framework for exempt entities that contract with federal and/or state governments must take account of both contract performance in substantive terms and continuing qualification for exemption from federal and state taxation.*

*Government contracting means that government programs financed by taxpayer money are implemented by entities that are not themselves government agencies. The emergence of what some analysts have called "government by contract" raises difficult and important issues of accountability.<sup>1</sup> Accountability requires monitoring of contractors to prevent fraud and abuse and to ensure that government programs are being implemented as intended in the interests of the beneficiaries. These issues are best understood as applying to all government contractors, without regard to their tax status. At the same time, in part because there has been little attention to issues of accountability in the case of exempt entity contractors and in part because it is sometimes suggested that problems of accountability would be less pressing if exempt entities played broader roles in the "contracting state," directing some attention to issues of accountability and monitoring in the case of exempt entities as government contractors could advance the understanding of both tax exemption and government contracting.*

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<sup>1</sup> Jody Freeman, *The Contracting State*, 28 FL. S. L. Rev. 155 (2000). See also, JODY FREEMAN AND MARTHA MINOW, *GOVERNMENT BY CONTRACT: OUTSOURCING AND AMERICAN DEMOCRACY* (Harvard University Press, 2009).

*This paper focuses on three issues of accountability and monitoring applied to exempt entity contractors. The first issue is what questions should be the focal points of monitoring and accountability. The second issue is which agency or agencies might most effectively monitor exempt entities in their roles as government contractors. The third issue is whether exemption is a proxy for a well-designed system of accountability monitoring.*

*This paper suggests that the focal points of monitoring and accountability should be (i) prevention of fraud and abuse and (ii) ensuring that government programs are implemented in a manner that achieves the purposes of the programs being implemented. With respect to the second issue, this paper takes the position that agencies with responsibility for implementing the substantive programs covered by the contract should generally play the leading roles in ensuring that taxpayers' money is used effectively to implement government programs. These agencies have the relevant expertise with both the core requirements and the various modifications that such agencies may have negotiated in particular cases. Effective monitoring of government contractors is inescapably grounded in expertise in the programs being implemented. The third issue arises in the form of claims that exempt entities do not require monitoring beyond the scrutiny associated with maintaining their tax exempt status. The weak form of this claim is that the IRS can provide adequate monitoring through its determination that the contractor continues to qualify for exempt status. The strong form of this claim is that exempt entities can effectively monitor themselves because they are defined by their mission. This paper expresses considerable reservations about the idea that tax exempt status can serve as an effective proxy for a monitoring with respect to either fraud and abuse or program implementation.*

*The paper begins with a discussion of exempt entities as government contractors. Part II discusses the concept of cooperative federalism as it relates to the implementation of government programs. Part III looks at issues of accountability and monitoring in two patterns of government contracting with exempt entities, the charity carveout pattern that reserves certain contracting opportunities to exempt entities and the conduit pattern in which a nonprofit, in some cases one that benefitted from a charity carveout, subcontracts with a taxable entity. Part IV provides a brief conclusion that highlights issues to consider based on analyzing exempt entities as government contractors in a system of cooperative federalism.*

## **I. EXEMPT ENTITIES AS GOVERNMENT CONTRACTORS**

This paper does not claim to present a comprehensive account of exempt entities as government contractors. This is an area in which practice has developed far more fully than has either description or theory. Nevertheless, important studies dating back to the Reagan years provide an important foundation for any work that is done moving forward. Studies by Abramson and Salamon<sup>2</sup> and more recently by Elizabeth Boris and her colleagues<sup>3</sup> have

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<sup>2</sup> ALAN J. ABRAMSON & LESTER M. SALAMON, *THE NONPROFIT SECTOR AND THE NEW FEDERAL GOVERNMENT* (Urban Institute Press, 1986).

<sup>3</sup> Elizabeth T. Boris, Erwin de Leon, Katie L. Roeger, Milena Nikolova, *Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracting and Grants* (Urban Institute 2010)[the "2010 Urban Institute Study"]. See also a companion report by the National Council of

established the importance of government contracting to both exempt entities and to the federal government. Steven Rathgeb Smith and Michael Lipsky have established a foundation for future work on the impact of government contracting on the structure and operations of exempt entities.<sup>4</sup> The 2010 Urban Institute Study<sup>5</sup> and a report by a task force of distinguished New York lawyers and organization leaders working collaboratively with New York Attorney General Eric Schneiderman<sup>6</sup> have highlighted important problems arising from failures of both federal and state government agencies to fulfill their obligations under their contracts with exempt entities. Contracts are not signed and payments are not made in a timely manner, leaving exempt entities to finance government programs through what amounts to interest-free loans to government agencies.<sup>7</sup> The fact that this paper does not focus on this range of failures by governments to fulfill their contractual obligations should not be construed as minimizing the importance of these issues.

The 2010 Urban Institute Study focused on exempt entities that contract to implement human services programs, the area of government policy which has seen the greatest concentration of exempt entity contractors. The Study found that exempt entity contractors tend to be large and to hold multiple contracts. The Study has also documented a pattern of financial dependence of exempt entity contractors on government funding, although some exempt entity government contractors also engage in successfully in fund raising from private sources. Overall, the 2010 Urban Institute Study provides strong evidence that exempt entities are actively involved in extensive government contracting.

This article suggests that questions relating to exempt entities' performance as government contractors are important as well. In the Introduction, this paper identified and briefly discussed three issues raised by concerns over monitoring for accountability.<sup>8</sup> The first issue was the focal point of monitoring and accountability. As suggested in the Introduction, monitoring for fraud and abuse will always be necessary. Monitoring for fraud and abuse has been the central focus of most monitoring of most government contracts.<sup>9</sup> It has also been the

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Nonprofits, Cost, Complexification, and Crisis: Government's Human Services Contracting "System" Hurts Everyone (2010).

<sup>4</sup> STEVEN RATHGEB SMITH AND MICHAEL LIPSKY, *NONPROFITS FOR HIRE: THE WELFARE STATE IN THE AGE OF CONTRACTING* (Harvard University Press, 1993).

<sup>5</sup> Boris et al, *supra* note 3.

<sup>6</sup> Leadership Committee for Nonprofit Revitalization, *Revitalizing Nonprofits, Renewing New York: Report to Attorney General Eric T. Schneiderman* (Feb. 16, 2012). Contracting issues are discussed at 10-17. This Report also focuses on governance issues, including recommendations for strengthening the capacity of boards to play strong, active, constructive roles in organization governance. *See id.* at 23-33.

<sup>7</sup> Small businesses, which are most commonly subcontractors under contracts in which large taxable entities are the prime contractor, express many of the same concerns. *See* 76 Fed. Reg. 61626-61632 (October 5, 2011)(discussion of rules requiring that prime contractors include small businesses as a target percentage of their subcontractors).

<sup>8</sup> For a thoughtful discussion of the complexity of the concept of accountability, *see* Kevin P. Kearns, *Accountability in the Nonprofit Sector*, in LESTER M. SALAMON, ED., *THE STATE OF NONPROFIT AMERICA* 587-615 (Brookings Institution Press, 2012, 2d ed.)(discussing performance accountability at 596-601).

<sup>9</sup> OMB Circular A-122, *Cost Principles for Non-Profit Organizations*, 70 Fed. Reg. 51927-43 (Aug. 31, 2005). Circular A-122 provides that "[s]ome non-profit organizations, because of their size and nature of operations, can be considered to be similar to commercial concerns for purpose of applicability of cost principles. Such non-profit

focus of IRS audits of exempt entities.<sup>10</sup> This is necessary, but it is not sufficient. Exempt organizations that contract with federal or state or local governments require monitoring to establish their record of program performance. Both the taxpayer funded contracts and the taxpayer funded exemption from taxation can be defended only if and to the extent that exempt entities perform their contract obligations. The same is true with respect to program performance monitoring and accountability with respect to taxable entities that are government contractors.

Program performance monitoring, not just monitoring to prevent fraud and abuse, is important because exempt entities perform so many contracts in human services areas and, as a result, so often work with vulnerable people. The care of vulnerable people imposes a moral responsibility on both the governments responsible for the programs and on the contractors who assist in implementing the programs because vulnerable people cannot protect themselves from abuse by those who are being paid with taxpayers' money to care for them. This is a solemn responsibility performed under difficult conditions. Stories of abuse are told repeatedly but seem to have little impact. Abuse of vulnerable persons may or may not correlate with evidence that the contractor engages in financial misdeeds as well. The two elements of monitoring are directed to different types of problems. Both are necessary.

The second issue is what agencies should play the leading roles in monitoring the performance of government contractors. This paper takes the position that the agencies that administer the programs, not the IRS, should take the lead. This paper suggests that the IRS is not the proper agency to engage in monitoring for contract performance. The case for making contract performance monitoring a responsibility of the IRS would be based on the argument that contract performance is part of the determination of whether the organizations is operating for an exempt purpose. But, the organization might well be doing something that could be consistent with its exempt purpose without fulfilling the requirements of the particular contract that provided funding for the activity. An exempt entity's mission is not necessarily coterminous with its contract obligations. The difference arises not because the organization is engaged in activities that are inconsistent with its exempt status but because its activities may not be consistent with its contractual obligations to implement a government program. As the discussion in Part III of cooperative federalism indicates, federal programs are administered throughout a complex array of federal-state-local relationships that quite commonly involve programs modifications. Contracts with particular contractors may incorporate additional program modifications, but it is not possible to say much about these without access to the contracts through which various programs are implemented. Performance monitoring is difficult even without these variations.

The third issue is whether exempt status could serve as a proxy for program performance monitoring. This paper suggests that the idea that exempt entities are less likely to engage in

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organization shall operate under Federal cost principles applicable to commercial concerns." Id. at 31928. Appendix C to Circular A-122 provides of list of these organizations. Id. at 31943.

<sup>10</sup> The IRS has devoted significant resources to implementing section 4958 dealing with excess benefit transactions and its relationship with the concepts of private benefit and inurement. At times, it seems that attention to whether exempt entities are operating for an exempt purpose through activities consistent with that purpose receives less administrative attention to the cluster of private benefit doctrines.

activities that fall into the general category of fraud and abuse and more likely to excel in terms of program implementation is an assumption without any empirical basis. Assumptions, often unarticulated and inchoate, that exempt entities provide greater skills and insight while requiring a lesser degree of monitoring with respect to either fraud and abuse or program performance, seem to be part of the rationale for special preferences for exempt entities in government contracting. No one has developed a plausible argument for this approach, much less provided evidence supporting it. Based on what is now known, exempt status does not mean that monitoring is unnecessary. This claim could not be supported even if the organization's mission aligned closely with the functions it would perform under the government contract. Conflating the contract with assumptions about an organization's mission and its track record in pursuing that mission effectively are matters for research, not a premise for defining contract terms. To date, little such research has been done, in part because government programs are complex and because data about implementation are not available.

Among the questions that remain unaddressed is whether exempt entities that are performing government contracts in fact have relevant prior experience in providing services in the same or similar areas. While it is common to note that many of the areas now financed through government programs were once provided by exempt entities, these social histories say nothing about whether contemporary exempt entities that provide services under government contracts have any relevant experience. These social histories also gloss over the differences between private charity and government programs. One relevant distinction is the relationship to beneficiaries. At least in an earlier era, charities could and did choose their beneficiaries. Government programs began with a very different premise that treated beneficiaries as citizens entitled to equal treatment if they qualified for participation in a government program.<sup>11</sup> The change from government funding of entities that implement programs to funding of the beneficiaries in the form of vouchers has also brought marked changes from the historical premise that a charity chooses its beneficiaries.<sup>12</sup> These differences are not simply a matter of who participates in programs and on what terms. They are also a matter of how programs are designed and implemented.

There is little information on what operational capabilities might be characteristic of exempt entities that seek government contracts and what characteristics might be correlated with successful contract performance. For example, do exempt contractors with a previous track record in privately funded efforts have a better record of successfully implementing government contracts in the same policy areas? Or, does experience with the various systems of government contracting play a more important role?<sup>13</sup> Does implementation improve over time? What

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<sup>11</sup> Karen M. Tani, *Welfare & Rights: Before the Movement: Rights as a Language of the State*, 122 *YALE L.J.* 314(2012)(detailing the use of the language of rights by the federal government during the New Deal to address issues of federalism and administrative capacity as public support programs shifted from a framework of local "poor laws" to a framework of federal and state programs).

<sup>12</sup> For a useful overview, see Kirsten A. Gronbjerg & Lester M. Salamon, *Devolution, Marketization, and the Changing Shape of Government-Nonprofit Relations*, in LESTER M. SALAMON, ED., *THE STATE OF NONPROFIT AMERICA* 549-86 (Brookings Institution Press, 2012, 2d ed.).

<sup>13</sup>The complexity of government contracting requirements reflects statutory requirements and administrative requirements relating to matters of both substance and procedures. Identifying these requirements is one of the main challenges of designing better systems for government contract implementation.

metrics are most useful in understanding contractor performance? Is it possible to determine whether the operational characteristics of the contracting exempt entity or the characteristics of the government system of contracting are more important in shaping contract outcomes?

Understanding these issues depends upon understanding what exempt entities are contracting to do. Understanding what exempt entities are contracting to do requires analysis of contracts that exempt entities sign. Issues of the program content, the procedural requirements, the beneficiaries intended to be served are all matters that should be specified in the contract. This information is essential for understanding if the claims of exempt entities to special expertise are warranted and for thinking about reasonable performance metrics. Indeed, even the contracts themselves are not readily available, and research based on reading the contracts has not yet found its way into much of the literature on government programs and government contracting.

These questions relating to what exempt entities have contracted to do are not answerable with current data. Data on government contracts are fragmented, dispersed, and incomplete. Both the government data base, USAspending ([www.usaspending.gov](http://www.usaspending.gov)) and the Pew Charitable Trusts database, Subsidyscope ([www.subsidyscope.org](http://www.subsidyscope.org)) do not yet provide confidence that it is possible to look at the broad scope of government contracts or the broad range of exempt entities that may be engaged in government contracting. It is heartening to learn that New York City has launched a new website, [www.CheckbookNYC.com](http://www.CheckbookNYC.com), much greater access to relevant information regarding city contracts.<sup>14</sup> The site is intended to provide information to public officials, who no longer have to request information from the Mayor's office, as well as to the public, including watchdog organizations. The source code of this site, developed using open-source software, will be made public for use by other governments.<sup>15</sup> The Aspen Institute recently unveiled a study on the future of "big data" on exempt entities that will permit the kinds of research that are still out of reach do to the time and costs involved.<sup>16</sup>

Better data available in more usable formats will not solve all of the issues involved in monitoring and accountability. Exempt entities at times find performance monitoring and accountability inconsistent with their own sense of their missions. Exempt entity contractors may view funding through a government contract as indistinguishable from funding through private contributions.

This is not likely to be an analytically useful approach. It risks neglecting issues of accountability and program performance monitoring that should be central in any system based

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<sup>14</sup> David M. Halbfinger, *New Site Makes It Easier to View City Spending*, The New York Times, Jan. 22, 2013. The Report to the New York Attorney General, *supra* note 6 had recommended this kind of web site for the state of New York, but it did not discuss public access.

<sup>15</sup> David M. Halbfinger, *New Site Makes It Easier to View City Spending*, The New York Times, Jan. 22, 2013.

<sup>16</sup> Beth Simone Noveck and Daniel L. Goroff, *Information for Impact: Liberating Nonprofit Sector Data* (The Aspen Institute, 2013). The study was discussed at a conference entitled *Liberating 990 Data: How "Big Data" on the Nonprofit Sector Can Spur Innovation, Knowledge and Accountability*, held at the Aspen Institute in Washington, D.C. on January 31, 2013 and available on the Aspen Institute web site. This program included remarks by Jonathan Greenblatt, Special Assistant to the President and Director on the Office of Social Innovation and Civic Participation in the Domestic Policy Council.

on the use of taxpayer money. It is perhaps worth remembering that Hansmann's work is based on the importance of assuring donors that their contributions will be used for the intended purposes, not to enrich organization managers or other insiders.<sup>17</sup> This theory has led to a focus on preventing private benefit, which has been an important development, but it has led some to conflate preventing fraud and abuse with implementing the organization's mission. The same risk is present in considering the roles of exempt entities as government contractors.

These issues may soon become quite prominent among exempt organizations managers, advisers, and the government officials charged with implementing government programs. On January 11, 2013, the Supreme Court granted the petition for certiorari filed by the United States Agency for International Development (USAID) in *USAID v. Alliance for Open Society*.<sup>18</sup> The Court stated the question presented in the following terms: "Whether the United States Leadership Against HIV/AIDS, tuberculosis, and Malaria Act of 2003, 22 U.S.C. 763(f), which requires an organization to have a policy explicitly opposing prostitution and sex trafficking in order to receive federal funding to provide HIV and AIDS programs overseas, violates the First Amendment."<sup>19</sup> This case, in effect, raises issues of whether a government contract is a grant to an organization to pursue its own priorities or a contract with a government agency to implement a government program. This case does not raise federalism issues, which make questions of monitoring and accountability even more complex.

## II. COOPERATIVE FEDERALISM

Any reference to federalism is likely to evoke strong reactions because federalism is both a structural principle of our constitutional system and a political ideology invoked for partisan advantage. The operational consequence is that federalism is invoked to limit the federal government while serving as the framework for implementing government programs. The concept of federalism as a check on federal government authority is more fully developed than is the concept of federalism as a framework for implementing government programs effectively. Making government programs work involves "cooperative federalism," which is, of course, not always cooperative.<sup>20</sup>

Cooperative federalism is an operational reality without a well-developed legal framework.<sup>21</sup> Cooperative federalism relates primarily to program implementation. This means

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<sup>17</sup> Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L. J. 835 (1980); Henry B. Hansmann, *The Rationale for Exempting Nonprofit Organizations from the Corporate Income Tax*, 91 YALE L. J. 54 (1981).

<sup>18</sup> *USAID v. Alliance for Open Society*, No. 12-10 cert. granted 1/11/2013.

<sup>19</sup> The case below is *Alliance for Open Society Int'l. v. USAID*, 651 F.3d 218 (2d Cir. 2011), *aff'g* 570 F. Supp. 2d 533 (S.D.N.Y. 2008). For a discussion of this case in the context of Spending Clause jurisprudence and the state action doctrine, see Frances R. Hill, *Speaking Truth to the Power that Funds Them: A Jurisprudence of Association for Advocacy Organizations Financially Dependent on Government Grants and Contracts*, 15 N.Y.U. J. Legis. & Pub. Pol. 363 (2012).

<sup>20</sup> Jessica Bulman-Pozen and Heather K. Gerken, *Uncooperative Federalism*, 118 YALE L.J. 1256 (2008-2009).

<sup>21</sup> For a contemporary approach to exploring the relationships germane to cooperative federalism, see Abbe R. Gluck, *Intrastatutory Federalism and Statutory Interpretation: State Implementation of Federal Law in Health Reform and Beyond*, 121 YALE L.J. 534 (2011-12). For an analysis of the Roberts' Courts uncertain jurisprudence



that cooperative federalism implicates administrative agencies exercising their authority to promulgate regulations and other guidance for program implementation. Cooperative federalism also implicates the roles of agencies in monitoring the implementation of government programs by government contractors. This is federalism at a granular level that takes account of monitoring to enhance program performance as well as to prevent fraud and abuse.

The Supreme Court invocation of federalism as a limitation on federal government authority has brought renewed interest in the structure of the administrative state and efforts to understand the administrative state through analytical frameworks that incorporate federalism as well as the roles of non-governmental actors.<sup>22</sup> This has brought renewed attention to the Spending Clause<sup>23</sup> and to the conditions that may be imposed by the federal government that finances state participation in government programs and also finances contracts with exempt entities to implement these programs.

The Rehnquist Court, for all its concern with using federalism to limit federal government authority, nevertheless decided the foundational case in modern Spending Clause jurisprudence, *South Dakota v. Dole*, in a manner that gave the federal government broad latitude in imposing conditions on states that received benefits and participated in the administration of these programs.<sup>24</sup> The Court in *Dole* gave the idea of “coercion” arising from the federal government’s ability to deny participation to states that did not agree to certain conditions only passing attention.<sup>25</sup> The Roberts Court, in contrast, interpreted coercion far more centrally and expansively in *National Federation of Independent Business v. Sebelius (NFIB)* by defining coercion to include state dependency on federal funding.<sup>26</sup> To the Roberts Court federal funding was a trap in the guise of a benefit.<sup>27</sup>

The Spending Clause is not the sole constitutional predicate applicable to cooperative federalism. The Rehnquist Court took a far more restrictive approach to shared responsibility for implementing federal government programs in two decisions in the 1990s dealing with what has come to be called “commandeering.” These cases are expressly focused on the role of state governments, concepts of state sovereignty, and the importance of limiting federal power. These cases can be read through a variety of lenses. While they certainly address the structure of

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in the area of cooperative federalism, see Robert J. Krotoszynski, Jr., *Cooperative Federalism, the New Formalism, and the Separation of Powers Revisited: Free Enterprise Fund and the Problem of Presidential Oversight of State-Government Officers Enforcing Federal Law*, 61 DUKE L. J. 1599 (2011-2012).

<sup>22</sup> Heather K. Gerken, *Forward: Federalism All the Way Down*, 124 HARV. L. REV. 4 (2010-2011).

<sup>23</sup> United States Constitution, Article I, § 8, cl.1.

<sup>24</sup> *South Dakota v. Dole*, 483 U.S. 203 (1987).

<sup>25</sup> *Id.* at 211. The Court reasoned that “to hold that motive or temptation is equivalent to coercion is to plunge the law into endless difficulties.” *Id.*

<sup>26</sup> *NFIB v. Sebelius*, 132 S. Ct. 2566 (2012).

<sup>27</sup> This interpretative twist allowed the Chief Justice to uphold the Affordable Care Act while claiming that he limited the reach of federal funding and thus of federal authority. What this claim will mean for Spending Clause jurisprudence going forward is one of the important questions emerging from *NFIB v. Sebelius*. For one view of the importance of the case on this point, see Gillian F. Metzger, *To Tax, To Spend, To Regulate*, 126 HARV. L. REV. 83 (2012).

federalism, they also seem to promote an ideological agenda that is perhaps reconcilable with the Constitution but is not compelled by the Constitution. In *New York v. United States* the Court held that Congress could not require the states to enact or to implement federal government programs.<sup>28</sup> Congress had enacted a statute requiring each state to dispose of radioactive waste generated in the state and setting forth both monetary incentives and sanctions to enforce compliance by the states. The Court distinguished this case from cases subjecting states to generally applicable law to which both the states and private parties are subject. The Court stated that its decision focused solely on a statute that required a state government to implement a federal government program. The Court found that permitting the federal government to require the states to regulate undermined accountability by shifting the public perception of which government was primarily responsible for the regulation.<sup>29</sup>

In a second case dealing with joint federal-state implementation of a federal government statute, the Court prohibited what it called “commandeering” state employees to play a role in implementing federal government programs. In *Printz v. United States*, the Court held that the federal government lacked the authority to “command” state and local law enforcement officers to conduct background checks on prospective handgun purchasers.<sup>30</sup>

These two decisions by the Court suggest that federalism is based on clear distinctions between the federal government and state governments, with each autonomous in its own sphere.<sup>31</sup> This concept of federalism may serve some purposes but it does not capture the operational complexity of cooperative federalism. The question, which is largely beyond the scope of this paper, is whether the theory of federalism based on dual sovereigns can be reconciled with cooperative federalism or whether it imposes unworkable and ill-considered limits on state officials when they are operating in a system of cooperative federalism.

Another constitutional predicate that shapes cooperative federalism is the Supremacy Clause,<sup>32</sup> which permits the federal government to preempt state laws in particular cases. The Supreme Court has decided hundreds of preemption cases without developing a overarching or synthesizing jurisprudence of preemption, although courts appear to support preemption in a broad range of cases. For the purposes of this paper, it is important to note that preempting state law is not the same thing as cooperating in implementing federal law in cases where state law has been preempted. Waivers of the requirements of federal law can be understood in at least

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<sup>28</sup> *New York v. United States*, 505 U.S. 144 (1992).

<sup>29</sup> The Court elaborated on its reasoning in the following terms: “States are not mere political subdivisions of the United States. State governments are neither regional offices nor administrative agencies of the Federal Government....The Constitution permits both the Federal Government and the States to enact legislation regarding the disposal of low level radioactive waste. The Constitution enables the Federal Government to pre-empt state regulation contrary to federal interests, and it permits the Federal Government to hold out incentives to the States as a means of encouraging them to adopt suggested regulatory schemes. It does not, however, authorize Congress simply to direct the States to provide for the disposal of the radioactive waste generated within their borders.”

<sup>30</sup> *Printz v. United States*, 521 U.S. 898 (1997).

<sup>31</sup> For critiques of the “autonomy” model of federalism, see Bulman-Pozen and Gerken, *supra* note 20 and Heather K. Gerken, *supra*, note 22.

<sup>32</sup> United States Constitution, Article VI, cl. 2.

some instances as alternatives to complete preemption of state programs even when federal law formally preempts state law. The relationship between preemption and cooperative federalism remains to be explored.<sup>33</sup>

This paper focuses on cooperative federalism as a framework for implementing government programs, including monitoring government contractors. This involves monitoring to prevent fraud and abuse and monitoring to ensure that government programs are implemented for the public benefit in a manner consistent with the choices made by government officials charged with designing and implementing these programs. This is a process marked by contingency and adaptation at many points. It is difficult, and perhaps unwise and unhelpful, to generalize about the utility or disutility of the multiple processes of adaptation that characterize the implementation of government programs. This paper presents instead an inventory of patterns that define at least some of the settings in which cooperative federalism takes place. This inventory does not pretend to constitute a model or a theory of cooperative federalism. It is more like a checklist meant to stimulate discussion of where cooperative federalism in program implementation takes place, how monitoring and accountability might develop in these settings, and what limits to cooperative federalism might either undermine or promote program effectiveness while safeguarding constitutional values. The patterns of cooperative federalism include, but may not be limited to:

- (1) State programs implemented by state officials pursuant to state statutes and regulations, funded by state revenue for the benefit of the people of the state who are the intended beneficiaries of the program
- (2) Federal programs implemented by federal officials pursuant to federal statutes and regulations, funded by federal revenue for the benefit of the people of the United States who are the intended beneficiaries of the program
- (3) Federal programs implemented by federal and state officials pursuant to federal statutes and regulations, which may include conditions imposed on states that choose to participate in the programs, and including waivers obtained by individual states, for the benefit of the people of the United States in light of modifications applicable to the people of particular states that negotiated waivers with federal agencies responsible for implementing the program.
- (4) Federal officials shaping or interdicting state implementation of state programs based on claims of conflicts with constitutional protections of beneficiaries' rights
- (5) Federal officials preempting state implementation and enforcement of state programs based on federal claims of state interference with federal programs under the preemption doctrine.

The first two patterns are consistent with the idea of the federal and state governments as separate sovereigns, but this is an idea more attuned to ideological federalism than to the

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<sup>33</sup> For a brief but thought-provoking discussion, see Bulman-Pozen and Gerken, *Uncooperative Federalism*, *supra* note 20 at 1302-07.

granular federalism of program implementation. These two patterns are more usefully seen as suggestions for research rather than as descriptions or conclusions. The third pattern is consistent with the structure of many of the largest government programs, including the social service programs in which exempt entities are most likely to become involved in program implementation as government contractors. The fourth pattern raises the issue of what entities protect beneficiaries in what circumstances. This issue is particularly important in human services programs dealing with vulnerable populations but it extends to issues like the denial of farm program benefits to African-American farmers by the U.S. Department of Agriculture. This matter was addressed as a denial of constitutional guarantees of equal protection. One of the issues arising in the contracting state is whether or in what circumstances contractors are treated as state actors. In the same vein, contractors are often not subject to the same ethics rules as those applicable to government employees. These issues deserve far more consideration than they are being given here or than they have been given in most discussions of government contracting. The fifth pattern addresses questions of which law applies when both the federal government and one or more state governments have programs in place. The practice of granting waivers to states and the pattern of negotiating contract-based modifications of government programs with particular contractors makes the relationship between preemption and implementation, monitoring, and accountability much more complex than may commonly be appreciated.

This inventory of patterns of cooperative federalism raises questions about where exempt entities in their roles as government contractors fit in a regulatory framework based on cooperative federalism. Like cooperative federalism, this issue does not lend itself to certainty or tidy charts purporting to account for all relevant dimensions of an issue. Whatever pattern of cooperative federalism may apply to particular programs, state revenue departments and the IRS as well as substantive agencies at both the federal and state levels are likely to be dealing with each other.<sup>34</sup> Government programs are implemented with considerable flexibility that results in substantial modifications of programs. The scope and nature of such modifications and their implications for government contracts for the provision of services has received little attention in discussions of cooperative federalism or in discussions of exempt entities as government contractors. The relationship between program modifications and contract modifications has not been systematically explored. This relationship raises questions about the terms of accountability of both the contractor and the government and their shared responsibility to ensuring that the benefits that are intended to result from the programs, and thus from the contract, in fact are provided.

### **III. CHARITY CARVEOUTS AND CONTRACTING CONDUITS: CAN COOPERATIVE FEDERALISM IMPROVE MONITORING, ACCOUNTABILITY AND CONTRACT PERFORMANCE?**

Exempt organizations' experiences as government contractors direct attention to two issues that have received little attention in the literature on government contracting. The first

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<sup>34</sup> Jody Freeman and Jim Rossi, *Agency Coordination in Shared Regulatory Space*, 125 HARV. L. REV. 1131 (2012). See also David Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955 (2004).; Keith Bradley, *The Design of Agency Interactions*, 111 COLUM. L. REV. 2217 (2011).

issue is described here as the issue of charity carveouts, a shorthand reference to a range of contracting preferences and relaxation of statutory and/or regulatory requirements in the case of exempt entities, particularly section 501(c)(3) public charities. The second issue is the role of exempt entities as conduits or accommodations parties in the contracting process. A conduit or accommodation party secures the contract but does not perform the work specified in the contract, which is subcontracted to one or more taxable entities. Subcontracting can be a means of enhancing contract performance.<sup>35</sup> The issue here is how to reconcile subcontracting with taxable entities with the claims made in support of charity carveouts. This issue relates directly to the larger question of accountability in government contracting, accountability for the use of taxpayer money to assist qualified participants in government programs. These questions have been identified in the preceding sections of this article. They are considered here in light of particular experiences based on publicly available information. This article makes no claims that these discussions provide a complete description of the two experiences. It also makes no claim that these two experiences described all, most, or even many government contracts involving exempt entities. At the same time, there is no evidence to suggest that they are so atypical or uncommon that they can be treated as irrelevant to understanding the requisites of a regulatory regime for exempt entities' contracting with federal and/or state governments.

#### ***A. Charity Carveouts: Credit Counseling***

Credit counseling organizations offer education regarding personal finances to people to have encountered financial difficulties. The IRS has since 1969 taken the position that credit counseling organizations that operate to educate the public can qualify for exemption as organizations described in section 501(c)(3).<sup>36</sup> Revenue Ruling 69-441 stated that the organization would provide educational information to the public on “budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications.”<sup>37</sup> In addition, the organization would aid “low-income individuals and families who have financial problems by providing them with individual counseling and, if necessary, by establishing budget plans.”<sup>38</sup> Under such budget plans, debtors would “voluntarily” make payments to the section 501(c)(3) organization, which would keep the funds in a trust account

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<sup>35</sup> There are numerous preferences applicable to government contracting. Most of these are intended to provide a benefit to the group identified as qualifying for the preference, such as veterans or small businesses, and do not argue that these individuals or entities offer a special legitimacy or expertise. *See*, for example, 76 Fed. Reg. 61626-32 (Oct. 5, 2011), for proposed regulations under the Small Business Jobs Act of 2010, applying to small businesses as subcontractors under a “covered contract” for which the prime contractor must submit a small business subcontracting plan

<sup>36</sup> Rev. Rul. 69-441, 1969-2 C.B. 115. In Rev. Rul. 65-299, 1965-2 C.B. 165 and Rev. Rul. 78-50, 1978-1 C.B. 155 the IRS relied on similar reasoning to find that a credit counseling organization qualified for exemption as an organization described in section 501(c)(4). For a detailed discussion of IRS actions with respect to credit counseling organizations, *see* FRANCES R. HILL & DOUGLAS M. MANCINO, *TAXATION OF EXEMPT ORGANIZATIONS* (Warren, Gorham, & Lamont, 2002, with biannual cumulative supplements) at ¶ 3.03[7] in the cumulative supplement.

<sup>37</sup> Rev. Rul. 69-441, 1969-2 C.B. 115.

<sup>38</sup> *Id.* This description is ambiguous on the issue of whether only low-income individuals or families were eligible for assistance. Later in the ruling, limitation on eligible beneficiaries to “those who were in need of such assistance as proper recipients of charity” was cited as a distinction between the section 501(c)(4) organization in Rev. Rul. 65-299 and the section 501(c)(3) organization in Rev. Rul. 69-441.

and distribute them to creditors who had approved the payment plan. These payment services were provided without charge to the debtor, and the full amount transferred by the debtor to the organization would be credited against the amount that each debtor owed to the participating creditor. The organization did not make loans to debtors or negotiate loans on behalf of debtors. The organization was primarily funded by contributions from participating creditors, but creditors could participate without making contributions to the organization. This ruling can be read as both defining limits and suggesting planning opportunities for those intent on abusing their exempt status.

In 1996 Congress enacted the Credit Organization Repair Act (CROA) to address serious abuses by credit repair organizations.<sup>39</sup> Among the most serious abuses targeted by CROA were charging debtors seeking assistance mandatory fees or pressuring debtors to purchase debt modifications plans. In addition, the organizations far too often failed to provide any meaningful assistance to debtors whom they had promised to assistance and from whom they had collected fees.

CROA defined credit repair organizations not to include “any nonprofit organization which is exempt from taxation under section 501(c)(3) of the Internal Revenue Code of 1986.”<sup>40</sup> The result was a “charity carveout” from the requirements of the Act. This carveout in CROA is consistent with the general jurisdictional principle in Section 5 of the Federal Trade Commission Act, which limits Federal Trade Commission (FTC) jurisdiction over nonprofits, certain banks, insurance companies, and common carriers.<sup>41</sup> These jurisdictional limits are based on the activities undertaken and, exception in the case of nonprofits, not solely on tax status.

The terms of the carveout raised the question of whether it applied to any organization that had a determination letter from the IRS recognizing it as exempt as an organization described in section 501(c)(3) even if was not operating in a manner consistent with its exempt status. The leading case addressing this issue is *Zimmerman v. Cambridge Credit Counseling*, in which the district court held that section 501(c)(3) status was sufficient to trigger the careveout,<sup>42</sup> but the First Circuit reversed on grounds that the language of the carveout required that an entity subject to the carveout did not base nonprofit status solely on exemption as an organization described in section 501(c)(3).<sup>43</sup> While this case prevented abusive section 501(c)(3) organizations from relying on their exempt status as a defense against claims that they had violated CROA and made it clear that courts could look at the actual operation of organizations even if they had determination letters from the IRS recognizing their exempt status, these cases left much of the responsibility with the IRS since organizations that were not

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<sup>39</sup> Credit Repair Organizations Act (CROA), 15 U.S.C. § 1679 et seq. (1996).

<sup>40</sup> 15 U.S.C. § 1679a(3)(B)(I).

<sup>41</sup> 15 U.S.C. § 44, 45(a)(2).

<sup>42</sup> *Zimmerman v. Cambridge Credit Counseling*, 322 F. Supp. 2d 95 (D. Mass. 2004). The same result based on similar reasoning was reached in *Limpert v. Cambridge Credit Counseling Corp.*, 328 F. Supp. 2d 360 (EDNY 2004).

<sup>43</sup> *Zimmerman v. Cambridge Credit Counseling*, 409 F. 3d 473 (1<sup>st</sup> Cir. 2006). For a district court decision reaching the same result on similar reasoning, *see Polacsek v. Debticated Consumer Counseling*, 423 F. Supp. 2d 539 (D. Md. 2005).

recognized as section 501(c)(3) organizations had no claim that CROA did not apply to them. The result was that credit counseling organizations continued to seek exemption, which made the problem worse. The result was an effort by the FTC, the IRS, and state authorities to stop the abuse of debtors by credit counseling organizations.

In simple numeric terms, the FTC brought twenty-three enforcement actions against debt relief companies.<sup>44</sup> The IRS has examine or sought information from almost 800 credit counseling organizations.<sup>45</sup> The IRS continues to deny exempt status to new organizations proposing to operate as credit counseling organizations and to revoke the exempt status of organizations that have been operating in a manner consistent with their exempt status.

This numerical comparison is not, of course, the whole story. The FTC promulgated regulations relating to deceptive or abusive practices in the telemarketing of debt relief services in its 2010 Telemarketing Sales Rule,<sup>46</sup> which was promulgated under the Telemarketing and Consumer Fraud and Abuse Prevention Act.<sup>47</sup> In addition, the broader effort against deceptive and abusive debt relief companies has depended critically on litigation by state officials pursuant to a range of state statutes. The FTC lists 244 state enforcement actions and states that it is aware of 10 others.<sup>48</sup> In the Preamble to the Telemarketing Sales Rule, the FTC described these state enforcement actions pursuant to state laws as “valuable” but also stated that “[t]he Commission agrees with the commenters who noted the advantages of a federal standard that is enforceable both by the FTC and the states, in particular the ability to obtain nationwide injunctive relief and consumer redress.”<sup>49</sup> The FTC also noted that Congress had preserved some scope for federal preemption of state laws in this area.<sup>50</sup>

In 2006 Congress added section 501(q) to the Internal Revenue Code.<sup>51</sup> Section 501(q) has been controversial, largely because of its reliance on governance mechanisms as an indicator of charitable purposes and as a method of preventing private benefit. These governance requirements are not unlike the reliance on the involvement of members of the community in health care organization boards to establish the organization’s commitment to community benefit. The larger question raised by section 501(q) is the efficacy of procedural requirements for monitoring performance. Without data on outcomes for participants in the programs offered by the credit counseling organizations, it is difficult to draw any conclusions. Yet, there is no consensus on metrics for participant outcomes and on the cost of engaging in these kinds of performance evaluations. This paper has suggested that exempt entities should not be immune from accountability and monitoring and that the IRS is not the appropriate agency for such

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<sup>44</sup> See the list of enforcement actions set forth in the Telemarketing Sales Rule, 75 Fed. Reg. 48458 (Aug. 10, 2010).

<sup>45</sup> See Hill & Mancino, *supra* note 31, at Supp. ¶ 3.03[7].

<sup>46</sup> Federal Trade Commission, Telemarketing Sales Rule, 75 Fed. Reg. 48458 (Aug. 10, 2010).

<sup>47</sup> 15 U.S.C. 6101-6108, as amended.

<sup>48</sup> Federal Trade Commission, Telemarketing Sales Rule, 75 Fed. Reg. 48458 (Aug. 10, 2010).

<sup>49</sup> *Id.*

<sup>50</sup> Telemarketing Sales Rule, *supra* note 39.

<sup>51</sup> See *id.* for a detailed technical discussion of section 501(q).

activities. Section 501(q) will be helpful for tax administration, but is unlikely to serve as an alternative to performance accountability.

The charity carveout has created a predicate for abuse of consumers, many of whom are people of limited means, by limiting the scope of FTC enforcement actions and imposing a regulatory burden on the IRS. When Congress limited the authority of the FTC, it unintentionally suggested an abusive planning tactic for bad actors seeking to profit from the economic troubles of others. The IRS has spent untold hours of staff time revoking exempt status of credit counseling organizations or denying applications for recognition of exemption as a organization described in section 501(c)(3).<sup>52</sup>

### ***B. Contracting Conduits: New Jersey Halfway Houses***

Subcontracting can enhance contract performance, but that outcome does not happen without careful attention to the assumptions made and the kind of monitoring that may be the most effective in various types of programs. The matter of the New Jersey halfway houses is a case in point.<sup>53</sup>

For reasons best known to itself, the state of New Jersey requires that state contracts for operating half-way houses be operated by section 501(c)(3) organizations. Operating a halfway house requires skills that appear to be possessed by a very limited number of entities, all of which are taxable. A taxable company that operates prisons and halfway houses in other states created a section 501(c)(3) for the express purpose of winning the contract with the state of New Jersey.<sup>54</sup> The founders and officers of the charity were executives of the taxable company, and the taxable company was the charity's sole member. The charity contract with its taxable parent and agreed to provide the entire amount received from the state to the taxable company, minus generous compensation for the charity's officers, all of whom were also officers of the taxable parent.

The New Jersey halfway houses were models of how not to operate a halfway house. Inmates came and went at will, and violent inmates terrorized those who were less violent. The guards feared the violent inmates and were unable or unwilling to protect the other inmates. At least one inmate was killed by other inmates. Inmates committed serious crimes while absent from the halfway house. No training for a successful transition to life outside of prison was provided.

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<sup>52</sup> For an extensive discussion of the denial or revocations of exempt status, see Hill & Mancino, *Taxation of Exempt Organizations* ¶ 3.03[7].

<sup>53</sup> The issues with respect to these halfway houses were the subject of an investigative report by Sam Dolnick in *The New York Times*. The individual entries in this series, all written by Sam Dolnick are: *As Escapees Stream Out, a Penal Business Thrives* (June 16, 2012); *At a Halfway House, Bedlam Reigns* (June 17, 2012); *At Penal Unit, a Volatile Mix Fuels a Murder* (June 18, 2012); *Christie Limits Legislature's Scrutiny of Halfway Houses* (June 29, 2012); *Finances Plague Company Running Halfway Houses* (July 26, 2012).

<sup>54</sup> The federal government finances many of the halfway houses in the United States, but there is no record showing that this contract was funded with federal funds.



The taxable company faced serious financial problems. The charity had no resources other than the amount from the contract with the state. There is no indication in the charity's annual information returns that it engaged in active oversight of any kind of the performance of the taxable company with which it had subcontracted the work under the state contract. This is scarcely surprising. It is unlikely that the charity officials would have monitored their own performance in their capacities as executives of the subcontractor.

No agency of New Jersey government seems to have been able to monitor the performance problems at the halfway houses despite the serious problems of public safety and the safety inmates that characterized the daily operations. The company president was a political supporter of the governor. The New Jersey tax authorities did not terminate the charity's exempt status under state law. The IRS has not terminated the charity's exempt status under federal tax law. This is surprising not only because of the facts in this matter but also because the IRS in 2012 issued a private letter ruling denying exempt status to a different organization created for the purpose of "applying for federal and state grants."<sup>55</sup> The IRS informed that organization that "you are operated primarily for a non-exempt purpose – to apply for and receive federal grant money for the benefit of LLC, a related for-profit entity."<sup>56</sup> There is no evidence that the IRS has applied a similar standard to the charity in the New Jersey halfway house case.

This may (or may not) be an extreme example of the downside of charity carveouts and the use of a charity as a conduit for winning a contract. This example suggests that exempt status has little if anything to do with effective performance of government contracts.

The relevant question for administrators is whether the exempt entity has the capacity for monitoring the performance of the subcontractor. It also suggests that charities that are simply alter egos of the subcontractor are unlikely to have this capacity. Thus, it might be possible to develop best practices guidelines that would mandate, at the very least, additional scrutiny in cases of this kind of relationship between the conduit charity and the entity that will perform the duties specified in the contract. Questions of the capacity for performing these duties and for monitoring the performance of the entity performing these duties are largely unrelated to tax status.

In this case, revocation of the exempt status of the conduit charity would seem to be important as a matter of the integrity of the law of exemption, but would be largely irrelevant to daily monitoring of contract compliance.

#### **IV. CONCLUSIONS**

The roles played by charities as government contractors offer one perspective on the larger issue of charities' relationships with government and with market entities. Exempt entities are enmeshed in complex relationships with both governments and markets and should be understood in terms of these relationships. Claims of distinctiveness as a basis for autonomy

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<sup>55</sup> PLR 201216040 (Jan. 26, 2012).

<sup>56</sup> *Id.*

from accountability cannot be reconciled with the multiple relationships through which exempt entities seek to achieve their exempt purposes.

Looking more closely at exempt entities in the contracting state could result in a number of benefits to both the exempt entity contractors and to government agencies. The question is whether it will result in better service to the intended beneficiaries, especially among the most vulnerable members of our state and national communities. Monitoring and accountability are important because beneficiaries must be the point of reference. The Supreme Court's ideological invocation of federalism in many instances makes the question of whether the federal or state government is responsible for implementing a program the central question. This is not the core question of either exempt status or cooperative federalism. The point of accountability under a properly designed and implemented framework of cooperative federalism is for the government actors and the contractors that participate in program implementation to share responsibility for ensuring that taxpayers' money is used for the designated purposes.

Without meaningful program monitoring, the program beneficiaries may not be properly served and the taxpayers' money may not be properly used. Monitoring based on tax status would not be plausibly considered in the case of taxable contractors, but it is claimed as plausible or logical in the case of exempt entity contractors. This paper expresses substantial reservations about the idea that exempt entities bring to government contracting any special virtue that reduces the need for or appropriateness of government monitoring of their performance and considerable skepticism about conflating performance monitoring with tax compliance.