

The Legal Meaning of Charity

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The Legal Meaning of Charity

What is a charity? Is it the same as a nonprofit organization? What about a tax exempt organizations? Some people might think this means a “501(c)(3)” organization, which would be a reference to the section in the Internal Revenue Code (IRC) defining organizations entitled to tax exemption and that also eligible to receive gifts that are deductible by their donors for income, estate, and gift tax purposes.

The Internal Revenue Service refers in its publications to organizations meeting the definition from section 501(c)(3) as “charities.” However, section 501(c)(3) provides that an eligible organization may have any one or more of the following purposes: “charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals.”

Treasury Regulations amplifying section 501(c)(3) expand this definition of charitable as follows:

The term charitable is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumerations in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of “charity” as developed by judicial decisions. Such terms include: relief of the poor and the distressed, or of the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

The statement that the term charitable is used “in its generally accepted legal sense” is a reference to the large body of English and United States state and federal statutes and cases that have fleshed out a definition of charity and charitable purposes, with roots in earliest common law in England. Thus to find the law of charity we must look not only to the federal laws set forth in the Internal Revenue Code, but also to much earlier precedents in the law of charitable trusts and charitable corporation found today in the laws of each of the states.

This paper describes the legal meanings of charity and of charitable purposes in both the Internal Revenue Code and current state laws, with the purpose of providing background for a search

for the answer to the question, “do we need a new law of charity?” The first section contains a description of the federal tax definition as it has evolved over the years since the first enactment of federal income tax provisions and how it continues to evolve today. The second describes the origins of the broader law of charity, with particular attention to its development in the United States. The third section shows the connection and overlap of current state laws, and compares them with those in the tax code and federal decisions. A final section attempts an answer to the question of whether this law of charity is obsolete.

The Legal Definition of a Charity in the Internal Revenue Code

The first three purposes listed in the current definition of exempt charitable purposes—charitable, religious, and educational—appeared in the first corporate income tax act passed in 1894, as well as the first personal income tax provision adopted in 1913. Although later declared unconstitutional, the act that followed in 1917 contained the same designations for tax exempt organizations, and provided for a deduction for charitable contributions with a limit of 15 percent. The additional purposes in current law were added in subsequent years, as certain organizations successfully lobbied Congress to have favored categories added to the enumeration.

An organization seeking exemption under section 501(c)(3) of the Internal Revenue must meet an organizational test requiring that the organization’s governing documents specify the purposes of the organization. It also requires that they contain prohibitions against specific activities that would also be in violation of certain other Code requirements for charitable organizations. These include providing private inurement to insiders or any private benefit, participating in political campaigns, and conducting substantial lobbying activities. Finally, in recognition that charitable assets must be preserved for future generations and not return to private hands, the organizing documents must contain assurances that on its dissolution or termination, its assets will be distributed only to other than tax exempt charities. These requirements contain, in essence, the federal tax definition of a charity. There is also an operational test that must be met before a determination of exemption can be granted. It requires that a charity must continue to abide by the original requirements for exemption in carrying out its purposes.

The regulation describing charitable purposes stresses that the definition is not simple or necessarily easy to pinpoint at any given time. In addition, compliance requires that one look not just at federal precedents, but state laws and cases, all of which have as their background a law of charity developed in England before 1601 (modified over time but with the basic concepts still in effect). This law of charity, with its definition of charitable purposes, was brought to the first colonies established in America and adopted in each of the states as it entered the Union, albeit with differing attributions as a

number of the original colonies refused to adopt the English common law and therefore adopted their own version of the law of charity. As with the definition of charity under state law, described below, the definition in the federal regulation illustrates that charity law is not stagnant, and will change from time to time to meet current public needs. Just as the three examples listed at the end of the quoted regulation reflect common concerns in 1959 when the regulation was adopted, examples of the current scope of charity and charitable purposes now include a number of purposes not anticipated at the time the regulation was formulated. Among them are protection of the environment, providing legal services to those unable to obtain them, low-income housing, new or expanded definitions of permissible beneficiaries of disaster relief and of the nature of and manner in which medical services can be provided, and the conduct of activities and solicitation of funds over the internet.

Each of these purposes has been the subject of subsequent rulings by the Internal Revenue Service, in some cases reinforced or developed in decisions of the Tax Court or the Federal District or Courts of Appeal where organizations seeking exemption can obtain judicial review of the decisions of the IRS and of the lower courts.

The problems of definition raised under some of the enumerated categories in section 501(c)(3) are discussed later in this section. However, a decision by the U.S. Supreme Court in 1983 affected the definition of any charity claiming exemption as described in any one of the purposes in the Code other than “charitable.” In this case, *Bob Jones University v. United States*, 461 U.S. 574 (1983), the court recognized the interplay of the common law and the tax laws, holding that a basic requirement for tax exemption as a charity was that the organization could not conduct activities that violate fundamental public policy, which was in this case discrimination on the basis of race. In other words, it was not sufficient that an organization meet the definition of “religious,” or “educational,” it also had to meet all the other requirements for all charities such as having indefinite beneficiaries, providing no public benefit or inurement, and not having purposes that are illegal or—as in this case—a purpose that was in violation of the laws prohibiting racial discrimination (a practice that was against what was described as “fundamental” public policy).

In a concurring opinion, Justice Powell expressed concern that the decision might have the effect of limiting the rights of dissent of charitable organizations on matters of public policy. He also objected to the fact that the majority opinion appeared to leave the determination of what is fundamental public policy to the Commissioner of Internal Revenue, rather than to Congress. In the intervening years, the decision has not in fact been extended to limit all charitable dispositions, although the issue is far from resolved. The legality of affirmative action programs is currently before the court, as is the question of discrimination on the basis of sexual preference. And the ruling in the Jones

decision has not to date been extended to protection on the basis of sex, notably in regard to single-sex schools.

Considering the number of charities receiving determinations of exemption during the last fifty years, it is apparent that there has been little difficulty in dealing with the eligibility of charities helping the poor, literary organizations, organizations testing for public safety, fostering international amateur sports competition, preventing cruelty to children or animals, or testing for public safety. There have been and continue to be a large number of disputes over eligibility for exemption have involved charities that claim to be religious, or specifically churches; as well as those whose purposes were educational, providing health care, or more generally providing benefit to the public (lessening the burdens of government).

Religious Organizations and Churches

In the realm of religious organizations, the issue of legitimacy of a church has been a recurrent problem. Television ministries were of concern during the 1970s and 1980s, as were the operations of the Church of Scientology. The IRS ultimately reached a settlement with the church, which resulted in the continuing operation of the church. The matter is of continuing interest. Richard L. Schmalleck in a paper prepared for the Annual Conference of the New York University Center for Law and Philanthropy in 2011, reported on his analysis of cases brought by charities seeking exempt status by means of a declaratory judgment procedure made available with enactment of IRC section 7428 in 1976. There were a total of 185 cases decided between 1977 and the end of August 2011. Eligibility of churches for exemption constituted approximately one quarter of the litigated cases on charitable status. He describes a number of cases dealing with what were described as “mail-order churches,” religious organizations that offered charters to those who wanted to establish their own churches, which would be their own homes. The IRS, conscious of the constitutional restraints in the First Amendment, has never issued regulations governing religious organizations and churches, but has attempted through a number of Revenue Procedures and Rulings to define what constitutes a religious organization and a church, some of which have been rejected by the courts as too restrictive. The IRS is hampered in its efforts to regulate organizations claiming to be churches by virtue of the fact that churches do not need to seek determinations of exemption, are not required to file annual information returns and the Church Audit Procedure Act of 1984 which requires that a senior official of the IRS has a “reasonable belief” that a particular church may not be entitled to exemption. This act also gives churches certain procedural protections not available to other exempt charities.

Educational Purposes

Treasury regulations issued in 1959 defined “educational purposes” as the instruction or training of the individual for the purpose of improving or developing his capabilities, or the instruction of the public on subjects useful to the individual and beneficial to the community. Thus, it was made clear that charities with educational purposes included not just schools, colleges, and universities, but also libraries, public discussion groups, including those with programs on radio or television, correspondence courses and the even larger category of museums, orchestras, and other cultural organizations.

An important issue for the IRS in regard to educational charities was distinguishing between organizations that were considered purely educational and those that were considered “action” organizations, not eligible for exemption under section 501(c)(3), but possibly described in and tax exempt under section 501(c)(4) as social welfare organizations. (This meant that they would not be eligible to receive tax deductible contributions.) The distinguishing difference between a charity and an action organization is that a charity is not permitted to undertake other than unsubstantial lobbying, and the question the IRS attempting to set forth in the regulations was under what circumstances would an organizations’ publications or programs move from the preferred category of educational to the less favored group of so-called advocacy organizations.

A portion of this regulation was declared unconstitutional in 1980 in the case of *Big Mama Rag v. United States*, 631 F.2d 1030. The U.S. Court of Appeals for the District of Columbia overturned a decision of the District Court for the District of Columbia that had upheld the IRS denial of exemption to Big Mama Rag on the basis that the organization did not satisfy the definitions of educational and charitable because it could not meet the requirement in the regulations that it must present a sufficiently full and fair exposition of the pertinent facts to permit an individual or the public to form an independent opinion or conclusion, but rather was presenting unsupported opinion, in its case, publishing a feminist-oriented monthly magazine. The Court of Appeals held that the definition in the regulations lacked sufficient specificity to pass constitutional muster on the grounds that the standard was vague both in describing who is subject to the test and in articulating its substantive requirements.

In 1986, the IRS issued Revenue Procedure 86–43, with the stated purpose of publishing the criteria adopted and then used by the IRS to determine the circumstances under which advocacy of a particular viewpoint or position by an organization was to be considered educational within the meaning of section 501(c)(3). Called the methodology test, it was intended to meet the standards in the Big Mama Rag case, and was held constitutional in the case of *The Nationalist Movement v. Commissioner*, 102 T.C. 558, aff’d 37 F/3d 216(5th Cir. 1994), cert. denied, 513, U.S. 1192 (1994).

The Pension Protection Act of 2006 contained a section designed to address a type of abuse in a small, but highly publicized, segment of exempt organizations with educational purposes: credit counseling organizations. The earliest prototypes of these organizations were established to provide education and free counseling to individuals about use of credit and sound financial practices without charge, primarily to low-income families. However, the nature of these organizations changed over the years, growing five-fold between 1990 and 2002, at which time there was an estimated total of 1,000 organizations in existence. Instead of free counseling, they were charging for their services and encouraging consumers to sign up for debt management plans, from which they, and for-profit entities they controlled, received a portion of the fees. Congress' response to the evidence of abuse was to enact a set of specific restrictions on organizations of this nature, carving them out from the general tax exemption provisions and mandating that they meet requirements in a new section 501(q) relating to composition of their governing body, limits on permissible practices, rules about ownership of subsidiary companies and related entities, and other very specific requirements. The extent of specificity in these provisions was unprecedented. In a testimony before the House Committee on Ways and Means, Subcommittee on Oversight (Hearing on Tax Exempt Organizations, May 16, 2012) Roger Collinvaux noted that the legislation represented a significant conceptual shift, from a policy based on finding that if you have a good purpose, the law will not discriminate because of such purpose. By focusing on process, and not questioning the nature of the purpose, however, the legislation was not addressing more basic questions raised by the proliferation of the entities compromising the charitable sector and the apparent failure of the Internal Revenue Service to adequately prevent abuse.

Hospitals and Other Health Care Entities

Health care was included in the original definitions of charitable purposes and hospitals were considered within the original category of exempt charities. However, with passage of Medicare and Medicaid, the IRS began to question or not whether organizations that relied solely on reimbursements from third parties for financial support were entitled to tax exemption. In an early ruling, exemption was conditioned on providing free care to those who could not pay. In 1969 the IRS adopted a community benefit standard that abandoned the free care requirement and could be met if the hospital operated an emergency room available to all, although there were other ways to demonstrate community benefit, such as educational programs available to the community. The emergency room requirement was modified in 1983 by permitting a hospital to demonstrate that its operations duplicated emergency services available in the community and that it was providing other types of community benefits. After a number of congressional hearings on the appropriate scope of the exemption for hospitals (including some calls for removal of exemption entirely), Congress added new requirements

for hospitals seeking exemption under section 501(c)(3), contained in a new section, 501(r), of the 2010 Patient Protection and Affordable Care Act. Among them, and relating to their charitable purposes, hospital organizations are required to conduct a community health needs assessment at least once every three years and adopt an implementation strategy to meet the identified needs. Sanctions were imposed for failure to comply. Hospitals are also required to adopt financial assistance and emerging medical policies that do not discriminate against individuals qualified for financial assistance. Thus, the new requirements are melded with the old, modifying by statute the common law's far more broad and open-ended standard. The legislation reflects a new approach to describing a charitable purpose for tax purposes, and, by imposing a monetary sanction in addition to revocation of exemption, reflects a new legislative approach to defining the general category "charity" by separating one of its components and imposing process-driven requirement to demonstrate its "charitability" rather than dealing with the entire range of charities.

There is another provision in the Treasury regulations, section 1.501(c)(3)-1(b)(5) that recognizes a connection between federal and state law.

The law of the state in which an organization is created shall be controlling in construing the terms of its articles... However, any organization which contends that such terms have under State law a different meaning from their generally accepted meaning must establish such meaning by clear and convincing reference to relevant court decisions, opinions of the State attorney general, or other evidence of applicable State law.

In practice, it has never been easy to persuade a federal tax agent with no legal training that state law differed from his view of the tax law, but the regulation contains the basis for recognizing a new purpose, if state law has allowed a purpose that has not yet been recognized in the tax law. Yet it remains, if federal tax precedents do not answer questions yet to be asked.

What might be described as the federal or federal tax side of the law of charity has involved expansion of the definition of charitable purposes just as it was anticipated in the period when the common law of charitable trusts was evolving, with rules in place to assure that favored status will not be given in the first instance to entities that do not meet the basic definition of a charity. Federal tax law has permitted growth and change in the universe of charities. Modern day problems involve business activities, whether they have too-commercial a bent, whether an entity can be charitable if it relies solely on fees for its services, and questions of self-dealing, and most recently, proper governance. Attention has not focused on definitions of charitable purposes. Instead, recent legislation dealing with credit counseling organizations and hospitals has been directed toward activities, the manner in which charitable purposes are carried out (in other words, whether or not they pass the operational test). It

remains to be seen whether this will be a precedent whereby certain categories of charities with common purposes are singled out and subject to special restrictions, or whether, with congressional interest in reviewing the rationale for charitable deductions, the focus on the broad categories of charities and mete out benefits in accordance with the worth these organizations are providing to society. If that is the case, the federal tax law of charity could be the subject of major changes.

The Law of Charity in the States

A law of charity was first formulated in England in the fifteen hundreds. At the same time private trusts were recognized by the courts, trusts for certain uses or purposes were held to be legal if those purposes were of benefit to the public and their beneficiaries were an indefinite part of the public. These charitable trusts, unlike private trusts, were permitted perpetual life and the right to accumulate reasonable amounts of principal. Corporations for religious purposes were also given legal status, subject to the rules applicable to charitable trusts. A body of law governing charities was first codified in the Statute of Elizabeth of 1601, called the Statute of Charitable Uses.

The preamble to this Statute of Charitable Uses (purposes) contained a list of the purposes for which charities had been and were being established. This list included relief of aged, impotent, and poor people; maintenance of sick and maimed soldiers and mariners; schools of learning, free schools, and scholars in universities; repair of bridges, ports, and havens; relief, stock, or maintenance of houses of correction; and relief or redemption of prisoners. As this came to be formulated as a list of charitable purposes, “relief of the burdens of government” was the phrase used to describe the last three categories.

In the nineteenth century, the English courts rephrased the list in the Statute of Elizabeth by referring to what were described in the judicial decisions as four “heads” of charity: relief of poverty, advancement of education, advancement of religion, and other purposes beneficial to the community not falling under any of the preceding three heads. Over the years, the English courts were very conservative in their interpretations of “charitable purposes.” It was not until 2006 that Parliament passed legislation in which the four heads of charity were increased to thirteen, and an overriding requirement that public benefit be demonstrated to qualify under each of them was added. The expansion of the permitted list of purposes was widely accepted, but the question of the manner in which the requirement for demonstrating public benefit could be met was soon the subject of litigation, notably in regard to the eligibility of schools that relied for support solely on tuition fees and provided no scholarships. The matter remains unresolved today.

A search to find the contemporary law of charity in the United States requires looking at a multitude of legal sources, in addition to the federal provisions in the Internal Revenue Code first described above; these include decisions of the federal courts interpreting Internal Revenue Code provisions as well as state laws where there is a dispute among the states, and state court decisions from all of the states and the District of Columbia. These laws, both legislative adoptions and judicial decisions, define “charity” and its component entities; state laws also govern the nature and composition of the legal entities that may qualify as charitable, primarily charitable trusts and nonprofit corporations; state tax laws grant exemption from income and sales taxes; and local municipal laws, in many instances authorized by a state constitution or the legislature, govern exemption from property taxes.

As noted above, current state laws and before the formation of the United States, the laws of the colonies all provided for the creation of charities, including a definition of charities and charitable purposes based on the English precedents. This included therefore, requirements that they benefit an indefinite class, that they do not further private purposes and that the charities’ purposes could not be illegal or against public policy.

The Restatement of Law, Trusts, Third, contains in section 28 what is considered the currently accepted definition of charitable purposes under state law. It includes the following purposes:

- a. the relief of poverty;
- b. the advancement of knowledge or education;
- c. the advancement of religion;
- d. the promotion of health;
- e. governmental or municipal purposes; and
- f. other purposes that are beneficial to the community.

In addition to meeting one or more of these categories, all charities are subject to three basic limitations: (1) the beneficiaries must constitute an indefinite class of individuals; (2) purposes that are beneficial to the community preclude the provision of impermissible private benefit to any individuals, including those who govern the charities and the indefinite members of the public who are the ultimate beneficiaries of these entities; and (3) an intended purpose is invalid if its purpose is unlawful or its performance calls for the commission of a criminal or tortious act or it is contrary to public policy.

The definition of charitable purposes in the draft Principles of the Law of Charitable Organizations follows this Restatement formulation with one exception. It changed the phrase “calls for the commission of criminal or tortious activity: to “requires the commission of criminal or tortious

activity,” explicitly adopting concepts of compulsion and materiality. In addition, the word “fundamental” was inserted before the phrase “public policy,” reflecting the Supreme Court decision in *Bob Jones University*, discussed in the first section, particularly the opinion of Justice Powell.

Other model state statutes, such as those approved by the Commissioners on Uniform State Laws that define charitable purposes, also follow the Restatement formulation. Thus, the Uniform Management of Institutional Funds Act, adopted in 1972, and enacted in almost every state, and the Model Protection of Charitable Assets Act, adopted in 2012, define charitable purposes as “the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of governmental purposes, or another purpose the achievement of which is beneficial to the community.” The Uniform Trust Code, first adopted in 2001, and in effect in 25 states has the same definition. In contrast, a Model Nonprofit Corporation Act, adopted by the Business Section of the American Bar Association in 2010, defines a “charitable corporation” as “a domestic corporation that is operated primarily or exclusively for one or more charitable purpose, and charitable purpose in turn is a purpose that would make a corporation operated exclusively for that purpose eligible to be exempt from taxation under Section 501(c)(3) or (4) of the Internal Revenue Code, or is considered charitable under law other than this [act] or the Internal Revenue Code,” bringing one full circle. Of note is the consensus on the definition, a development that occurred only in the latter part of the twentieth century and one that is likely to lead to less litigation than in the past, most of it likely confined to enforcement of charitable fiduciary duties. One of these, the duty of loyalty requires what in modern parlance would be phrased as a duty to carry out the mission of the organization, and it concomitant, namely that if the purposes can no longer be carried out reasonably, the fiduciaries must seek court permission to have them modified so that the charity can continue to provide public benefit.

The ability of the state courts to modify obsolete purposes of charities is one of the most important aspects of the early law of charity. It reflected a recognition that the purposes of charitable trusts which (unlike private trusts, were permitted unlimited life) would likely need to change over time if they were to continue to provide benefits to the public. This made it necessary to have a legal mechanism by which obsolete purposes could be reframed to meet changing needs of society. The answer devised in the early days of the common law of trusts was a doctrine called the doctrine of *cy pres*. This is now a part of state law in every state and applies not just to charitable trusts but, with some modifications, to the purposes of charitable corporations. Although state standards may vary to some degree, the Restatement of the Law Third, Trusts, describes in section 67 the doctrine of *cy pres* as follows: if a designated charitable purpose is or becomes unlawful, impossible, or impracticable to carry out, or to the extent it is or becomes wasteful to apply all of the property to the designated purpose, the

court will direct application of the property to a charitable purpose that reasonably approximates the originally designated purpose.

There are probably more litigated cases under state law in the nineteenth and early twentieth centuries involving this doctrine than those dealing with other issues affecting charities, primarily because the doctrine could be applied to reframe gifts with valid charitable purposes when they were written into a will, for example, but obsolete or implacable at the death of the testator. Under earlier versions of the doctrine, a showing of general charitable intent on the part of the creator was required, and this requirement was the basis of a large number of the early cases. This requirement was removed by statute in many states during the middle years of the twentieth century and it was not included in the new Restatement, making it far easier for the courts to apply the doctrine and giving heirs little or no standing to claim charitable assets because of a failure of purposes. The result is a decrease in the number of current cases in which the doctrine is involved. Nonetheless, it remains one of the most important aspects of the law of charity, although federal tax requirements for exemption that require a disposition on termination of a charity to another then-exempt charity have mitigated the need for state courts to be involved in the disposition of charitable assets.

Undoubtedly the leading early case in the American history of the law of charity was *Jackson v. Phillips*, 96 Mass. 539, 556 (1867) in which the court framed a definition of charity that was widely accepted for a long period as the standard definition. It held that “a charity, in the legal sense, may be more fully defined as a gift, to be applied consistently with existing laws, for the benefit of an indefinite number of persons, either by bringing their minds or hearts under the influence of education or religion, by relieving their bodies from disease, suffering or constraint, by assisting them to establish themselves in life, or by erecting or maintaining public buildings or works, or otherwise lessening the burdens of government.”

The Jackson case also validated the cy pres doctrine and affirmed that a trust could not be charitable if political action was the only means by which it could achieve its purposes. The case involved the validity of three testamentary trusts, one to create a public sentiment that would put an end to negro slavery, a second for the benefit of fugitive slaves that may have escaped from the slaveholding states, and the third to promote women’s suffrage. The testator died in 1861 and in 1865 the Thirteenth Amendment was adopted. The court rejected the claims of the heirs that the trusts all failed and applied the cy pres doctrine to uphold the first two trusts. After finding that the overall purpose of bettering the conditions of the African race had been fully accomplished by the abolition of slavery, the court held that the first trust was to be devoted to aiding former slaves in the states in which slavery had been abolished, and the second trust’s assets were to be applied to the use of “necessitous persons of African descent” in the city of Boston and its vicinity, preference to be given to

persons who had escaped from slavery. The third trust failed, however, because its purpose was to change the law and that could not be achieved without political action. The definition of charity, the application of cy pres, and the ruling regarding political activity in this case has been followed consistently in the ensuing years and is pertinent today.

There is a variant of the doctrine of cy pres which has been important in a number of judicial decisions in the past 50 years. Cy Pres is available when there is need to change the purpose of a charity. However, there are instances in which the methods, not the purposes, designated by the donor of the charity prevent the trustees from carrying out the purposes of the charity under current conditions. In this situation, the courts are permitted to modify those administrative provisions. This rule is called the doctrine of deviation, or equitable deviation, and the standards under which it can be applied and the scope of the remedies are broader than those under the doctrine of cy pres.

The difference between deviation and cy pres are not always understood by the courts. This has been especially evident in the cases in which the courts have been asked to remove racial restrictions in trusts and funds held by charitable corporations, with some courts considering the change as an administrative or distributive provision, and not a change of purpose, while others apply the cy pres doctrine. The issue has also arisen in a number of cases involving single-sex schools, an issue on which the state courts remain divided. The litigation involving the Barnes Foundation in Philadelphia over many years was ultimately resolved by the Pennsylvania Court of Common Pleas with application of the doctrine of deviation to permit the Foundation to move its collection of art to a new site in the city and remove the restrictions on access imposed by the donor.

The issue of whether and how a charitable hospital or health care organization could convert from charitable to private taxstatus was undoubtedly of the greatest public interest and impact in the field of charity law in recent years. Under the law of charity, once assets are devoted to charitable purposes, they may not be diverted to private purposes unless there is a sale or transfer in which the charity receives fair market value for the assets being transferred and the assets received by the charity are held for similar charitable purposes. Some of the earliest conversions were done without state regulation and the trustees received the proceeds from sale of the charity. In some instances, this diversion was not corrected. In one case the assets went to the state treasury. In a number of states, however, the state attorneys general and the courts were able to supervise the conversion process, assuring that the valuation of the charitable assets was fair and that under the doctrines of deviation or cy pres the assets would be held for similar charitable purposes. The determination of how broad those purposes could be varied among the states. Notably, the conversion of two Blue Cross Blue Shield organizations in California resulted in the establishment of two of the largest charitable trusts in the country, both dedicated to providing health care in their respective constituencies.

Despite the fact that federal tax exemption undoubtedly takes precedence for the founders of charities, the choice of the state under which a new charity is to be governed is left to the discretion of the founders. A charity can be formed as one of four types of legal entities: trusts, nonprofit corporations, unincorporated associations, and limited liability companies (which is a new legal form). In a number of states, the laws governing nonprofit corporations divide the eligible groups into three categories—public benefit, mutual benefit, and religious corporations, with the first category encompassing organizations with charitable purposes other than religion.

State charity law today is largely involved in assuring adherence to fiduciary duties and protecting charitable assets in transactions like mergers, dissolutions, and other forms of conversions. There are still some cases involving the definition of charitable purposes, many dealing with the question of whether they involve discrimination on the basis of race or sex. Restatement, Third, Trusts in Section 28 contains a list of these cases with short descriptions of the facts. As noted earlier, the elimination of a requirement of general intent in the cy pres doctrine has substantially decreased the number of cases involving claims by heirs. Charitable law also limits the standing of individuals to sue to enforce fiduciary duties, including a duty to carry out the purposes of the trust. These factors, combined with the reluctance of many state attorneys general to actively enforce breaches of duty, has contributed to the sparsity of judicial decision.

Charities seeking tax exemption most often adopt the sample founding documents provided by the Internal Revenue Service, assuring compliance with federal requirements, but also creating legal obligations that will be interpreted and enforced in the state courts, and establishing institutions that will be subject to oversight by state regulators. It is not a question of overlap, but more of parallel systems that have important similarities and also important differences. These differences are most notably in the sanctions applied for failure to comply. In regard to the question of finding a law of charity, the similarities are far greater than the differences, with the majority of them arising from the fact that the states' basis interest is in protecting charitable assets at their creation and as they are administered, while the federal interest is in protecting the integrity of the tax system.

State Tax Exemptions for Charities

State tax laws generally provide that exemption from federal tax is sufficient to permit exemption from state income and sales tax, although there have been instances in which state authorities imposed their own definition of charities seeking exemption from sales taxes. The issue of exemption from local property tax has been quite different in a number of states in recent years, most notably in Pennsylvania and Illinois. Exemption from local property taxes is generally determined by local (e.g., city or town officials) although this is authorized by the state legislature or constitution. Litigation in these two states

arose at the end of the 1900s over a phrase not found in the laws of the other states, namely that exemption was available to “institutions of purely public charity.” In Pennsylvania in 1985, the Supreme Court promulgated a five-part test for eligibility under this provision. Then in 1997, the state legislature passed an act designed to clarify the provisions of the Court promulgated test, an act that was described as “expanding the standards in the test well beyond what any appellate court had ever decided.” Despite this test, Brody reports that the courts differed on the definitions of purely public charity, both before and after the 1995 act, with the lower courts tending to construe the test strictly, while the Supreme Court was more accepting of an expanded definition. Although some anticipated a challenge to the constitutionality of the 1996 act, departing as it did from the Supreme Court ruling, that has not happened. Instead, the Supreme Court has to date deferred to the legislature.

In Illinois, the constitution permits the legislature to exempt certain types of property from exemption, including property used for school, religious, cemetery, and charitable purposes. A challenge to tax exemption of a major hospital was upheld in the case of *Provena Covenant Medical Center v. Department of Revenue*, 925 N.E. 3d 1131 (Ill. 2010), in a divided opinion in which the deciding justices raised three separate grounds for their decision. The issue was whether the organization provided sufficient charity care to justify exemption, and the three opinions differed on how to define such care and the means of measuring it. Thus the case does not provide clear precedent for Illinois, let alone other jurisdictions where the exemption of hospitals from property tax is being considered. These cases were of broad contemporary interest, with concern expressed that they might foreshadow a national trend. However, this has not been the case. Rather the issue of greater interest has been whether (and the extent to which) charities, particularly large charities in urban communities, should agree to make PILOTs (payments in lieu of taxes) a matter of concern in those places where the government does provide extensive services to tax exempt entities.

Comparison of Federal and State Definitions of Charity

As noted, the basic components of the tax requirements for charity status are (1) a legal entity with purposes that fit within certain enumerated categories, but one that also is open-ended and designed to permit change as the needs of society change over time; (2) a prohibition against permitting personal benefits to insiders and to other members of the general public, at the expense of the charity; (3) a prohibition against substantial lobbying activity; (4) a prohibition against any participations in any political campaign; (5) a requirement that its assets will always remain devoted to charitable purposes; and (6) a constitutional requirement that a purpose is not charitable if it violates fundamental public policy.

State law definition of a charity can be summarized as follows: it is (1) a legal entity with purposes that fit within specific categories of enumerated purposes, but is also open ended and designed to expand to meet changing needs of society; (2) a prohibition against providing individual private benefit; (3) an overall requirement that a purpose is invalid if it can be accomplished only through political action; (4) a prohibition against conducting any political campaign activity; (5) a requirement that a charity's assets must always remain devoted to charitable purposes; and (6) a requirement that a purpose is not charitable if it involves criminal or tortuous acts or is against public policy.

These are, then, two different definitions with almost complete overlap. Their differences between the two, in fact, arise from the nature of federal and state regulation of charities and the sanctions available for violations. The sanctions under federal law are imposition of excise taxes and revocation of exemption following procedures established by the Treasury and the IRC applicable to all taxpayers, including those exempt from tax. The sanctions under state law are imposed by the state courts, exercising powers that are called equitable. These include a wide variety of remedies from correction of misappropriations, removal of fiduciaries, imposition of penalties, and directing transfer of charitable assets to other charities, or changing purposes when the application of the cy pres doctrine is appropriate. The regulator is the attorney general of the state, who has almost exclusive power to assure protection of charitable assets with the ultimate power to correct abuse residing in the state courts. This means that the nature of prosecution for violation of the requirement for qualification as a charity and the applicable standards for compliance are very different under the two systems. It is perhaps because of these differences that not much attention is paid to the similarities.

The Law of Charity Is Pertinent Today, but Tomorrow Is Uncertain

The purpose of this paper has been to describe federal and state laws that together can be considered to comprise a law of charity. In its totality, this is not one that is easily found, although the early drafts of the American Law Institute Principles of the Law of Charitable Organizations have already begun to fill that vacuum and the Restatement of the Law, Third, Trusts is of great importance in compiling the state law cases dealing with charitable purposes. Due to the fact that the purposes of charities are permitted to change over time, the law of charity is not like other areas of the law where basic definitions tend to remain fixed. And this is possibly the distinguishing factor of this body of law—its built-in processes that permit change.

Critics of charity law, many of whom who are tax lawyers or economists or the staff of congressmen, look at the Internal Revenue Code provisions and see first, not the amount of dollars lost

by virtue of tax exemption, but see instead the amount of deductions for gifts to support charities, and they question whether the amount of the deductions outweigh the benefits charities are providing to society. Some critics argue that the deduction should vary depending on the nature of the charity, the services it provides, and the revenues it raises from activities it carries out, both exempt and taxable. Other critics would bifurcate the universe of charities, providing greater incentives for gifts to charities that provide an immediate and measurable service to society, harking back to the public concept of charity as help to the poor and needy. Many of these critics would likely not hesitate to add churches and other religious organizations to a preferred category of organizations. Others would add education, and soon it would become a free-for-all, bifurcating the universe of tax-favored organizations and likely leading to the demise of many organizations that support unfavorable causes or conduct esoteric studies.

There are also critics who find the law of charity too messy, too rigid, or not sufficiently in tune with modern life. Attempts to correct these shortcomings, however, are likely to lead to such fundamental changes in the nature of charities that their benefits to society might be totally lost. One can hope that the law of charity will not be so fundamentally changed but rather that there will be a broader understanding that a concept that has change built in to it can never be simple or straightforward, because the nature of change does not necessarily follow a straight line.

Note

There are a number of treatises on the law of charity that provide insights into its early development in the United States. Notable is Carl Zolman's *American Charity Law*, 1924, and Fisch, Freed, and Schachter's *Charities and Charitable Foundations*, 1974, with supplements published through 1979. Austin Scott provided important historical information and a comprehensive description of the law of charitable trusts and corporations in his treatise, *The Law of Trusts*, and in the first and second *Restatements of the Law, Trusts*, as did George G. and George T. Bogert in *The Law of Trusts and Trustees*. Professor Scott's work has been carried on and the treatise is now published as Fratcher and Scott, while Edward C. Hallbach, Jr. was the Reporter for Restatement of the Law, Trusts, Third. The work of Evelyn Brody as the Reporter of the Principles of The Law of Charitable Organizations has been noted as has that of Edward Halbach, Reporter for Restatement Third, Trusts. The case book, *Nonprofit Organizations*, by James J. Fishman and Stephen Schwarz, contains not only the most important state and federal cases, but also critical analyses of the issues involved and rich background information on the developments in state and federal charity law. *Nonprofit Law: The Life Cycle of a Charitable Organization*, by Elizabeth Schmidt, is another case book with thoughtful and incisive insights, framed from a practical point of view from the creation of a charity to its termination, covering state and federal issues arising in between these points. Additional studies by this author, *Foundations and Government* and *Governing Nonprofit Organizations*, have additional historical information and analysis.