

## Do We Need a New Legal Definition of Charity?

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## Do We Need a New Legal Definition of Charity?

What is a charity? Is it the same as a nonprofit organization? What about a tax-exempt organization? And what does charity mean? Is it relief of the poor and needy—a common usage of the word? Or is it a broader concept, encompassing a wide range of purposes considered to be providing benefit to the general public, not to private owners? Some people use a shortcut and speak of these organizations as 501(c)(3) organizations, a reference to the section of the Internal Revenue Code (IRC) that contains both the requirements for exemption from income tax for such organizations and, by cross references, their eligibility to receive gifts that are deductible by their donors for income, estate, and gift tax purposes. And it is in this connection that the question of whether we need a new law of charity is pertinent. As Congress considers tax reform, the favored position of organizations that qualify under section 501(c)(3) is under review, with some members looking to narrow the class to exclude all but those meeting the first definition of charity (aid to the poor and needy). This narrow look thereby opens the question of which, if any, other purposes should be included in the favored class, making the current legal definition obsolete.

In answering this critical question—do we need a new legal definition of charity?—this paper contains a review of the legal meanings of charity and charitable purposes in both the Internal Revenue Code and current state laws. The first section describes the federal tax definition as it has evolved since the first enactment of federal income tax provisions, and how it continues to evolve today. Section two 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 the law set out in the tax code and federal decisions. A final section concludes that the law of charities, based on centuries of historical precedent, is not only relevant in terms of current regulations, but also flexible enough to accommodate the changing needs of society. Whether the legal status quo will be preserved is an open question, and, doubtless, the boundaries will continue to evolve, as they have in the past.

### *The Legal Definition of a Charity in the Internal Revenue Code*

The Internal Revenue Service refers in its publications to organizations meeting the definition in section 501(c)(3) of the Internal Revenue Code as “charities,” thereby indicating that the legal meaning is not

the narrow one. Section 501(c)(3) itself 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 first clause defining the term charitable as it is used “in its generally accepted legal sense” incorporates a large body of English and US 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 state.

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. Although this act was later declared unconstitutional, subsequent tax enactments contained similar designations for tax-exempt organizations and provided for deductions for charitable contributions with the limits varying over the years. The additional purposes in current law—scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals—were added in subsequent years as certain organizations successfully lobbied Congress to have favored categories added to the enumeration.

Under current law, an organization seeking exemption under section 501(c)(3) of the Internal Revenue Code must meet an organizational test requiring that the organization’s governing documents specify the purposes of the organization. It also requires that the governing documents contain prohibitions against specific activities that would also be in violation of certain other Code requirements for charitable organizations. These prohibitions 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, the organization's assets will be distributed only to other tax-exempt charities. These requirements contain, in essence, the federal tax definition of a charity. Charities also must pass an operational test before a determination of exemption can be granted. The test requires that a charity continue to abide by the original requirements for exemption in carrying out its purposes.

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 that it will necessarily 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 manner in which funds are solicited from the general public. Each purpose 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 the lower courts.

There have been and continue to be disputes as to how the Service should interpret certain enumerated categories of charitable purposes in the Internal Revenue Code. The most important or controversial issues of contention are described later in this section. However, a decision by the US Supreme Court in 1983 affected the definition of all charities 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. In this case, it was discrimination on the basis of race. The holding of the Court was that it was not sufficient that an organization meet the definition of "religious," or "educational"; it also has to meet all the other requirements for all charities. This means having indefinite beneficiaries, providing no public benefit or inurement, and not having any purpose that is illegal or—as in the *Bob Jones* case—in violation of "fundamental" public policy laws, such as those laws prohibiting racial discrimination.

In a concurring opinion, Justice Powell expressed concern that the decision might limit 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 continues to come before the courts, as does the question of discrimination on the basis of sexual orientation. And the ruling in *Bob Jones* 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 past 50 years, it is apparent that there has been little difficulty in dealing with the eligibility of charities helping the poor, literary organizations, and organizations testing for public safety, fostering international amateur sports competition, preventing cruelty to children or animals, or testing for public safety. In contrast, there have been and continue to be a large number of disputes over eligibility for exemption involving charities claiming 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). These disputes are described in the following sections.

## **Religious Organizations and Churches**

In the realm of religious organizations, the issue of legitimacy of churches seeking exemption has been a recurrent problem. During the 1970s and 1980s, the courts dealt with several cases regarding television ministries. In a series of well-publicized events, the IRS and the courts struggled with the question of whether the Church of Scientology merited exemption as a religious organization. The IRS ultimately reached a settlement with the church that has since resulted in its continued recognition as a tax-exempt church.

The qualification for exemption for religious entities is of continuing interest. In a paper prepared for the annual conference of the National Center on Philanthropy and the Law in 2011, Richard L. Schmalbeck 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. A total of 185 cases were 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. Schmalbeck's paper outlines 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 homes as houses of worship. The IRS, conscious of the constitutional restraints in the First Amendment, has never issued regulations governing religious organizations and churches. However, it 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 the facts that churches do not need to seek determinations of exemption, are not required to file annual information returns, and uniquely benefit from the Church Audit Procedure Act of 1984, which requires that before opening an audit a senior IRS official must have 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 regarding 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 organizations operated exclusively for the promotion of social welfare. The distinguishing difference between a charity and an action organization is that donations to a tax-exempt charity are deductible, but the charity is not permitted to conduct other than unsubstantial lobbying and may not conduct any political campaign activities. An organization described in section 501(c)(4), in contrast, is not eligible to receive tax-deductible contributions but it is not subject to any limits on its lobbying activities and, as described below, may conduct a certain amount of campaign activity. The issue the IRS was attempting to address in the educational purposes regulations was under what circumstances an organization’s publications or programs would cause it to fail to qualify as an education charity, recognizing that it might still qualify under the less-favored category of “action” or advocacy organizations. See the “Advocacy Organizations” section (starting on page 7) describing the controversy that arose in 2013 over whether social welfare organizations could conduct political campaign activities and, if so, the amount of those activities that would be permitted.

A portion of these regulations describing valid educational purposes was declared unconstitutional in 1980 in the case of *Big Mama Rag v. United States*, 631 F.2d 1030. The US 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, an organization that

published a feminist-oriented monthly magazine by that name. The basis of the denial was 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. 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 in both describing who is subject to the test and articulating its substantive requirements.

In 1986, the IRS issued Revenue Procedure 86-43, 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 free education and counseling to individuals about use of credit and sound financial practices, primarily to low-income families. However, the nature of these organizations changed over the years as their number increased; the number of credit counseling organizations grew fivefold between 1990 and 2002, at which time an estimated 1,000 such organizations existed. 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's response to the evidence of abuse was to enact specific restrictions on organizations of this nature, carving them out from the general tax exemption provisions. In a new section 501(q), Congress mandated that credit counseling nonprofits meet requirements relating to composition of their governing body, limits on permissible practices, rules about ownership of subsidiary companies and related entities, and other requirements. The extent of specificity in these provisions was unprecedented. In testimony before the House Committee on Ways and Means, Subcommittee on Oversight in 2012, Roger Colinvaux noted that the legislation represented a significant conceptual shift from a policy based on finding that as long as the organization has a good purpose, the law will not discriminate by type of 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 IRS to adequately prevent abuse.

## **Hospitals and Other Health Care Entities**

Health care was included in the regulations' 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 had to address the question of whether organizations that relied solely on reimbursements from third parties for financial support were entitled to tax exemption. In a 1956 ruling, the IRS had conditioned exemption 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 making 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), in the 2010 Patient Protection and Affordable Care Act, Congress added new requirements for hospitals seeking exemption under section 501(c)(3), including a new section 501(r). Among the new requirements, hospital organizations must conduct a community health needs assessment at least once every three years and adopt an implementation strategy to meet the identified needs. Hospitals face sanctions for failure to comply. Hospitals are also required to adopt financial assistance and provide 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 specific types of organizations and imposing process-driven requirement to demonstrate a group's "charitability," rather than dealing with the entire range of charities.

## **Advocacy Organizations: Section 501(c)(4) Social Welfare Organizations**

In spring 2013, national attention was focused on the question of whether IRS personnel had exercised political bias while processing applications for exemption from organizations claiming to be social welfare organizations described in section 501(c)(4). The issue first came to public attention when the director of the IRS Exempt Division apologized at a meeting of the Exempt Organizations Committee of the American Bar Association's Tax Section for the agency's targeting of Tea Party-affiliated organizations and other predominately conservative groups between 2010 and 2012, a period that saw the number of applications for exemption more than double. The revelation drew the attention of

Congress, the administration and the public. The controversy led to the resignation of the acting director of the IRS, major changes in the leadership of the Exempt Division, and a review of current law and regulations by the Treasury Department. What emerged was not only administrative problems in the manner in which the Service was handling an influx of applications for exemption under section 501(c)(4), but inconsistencies in the manner in which it was making requests for additional information.

The uncertainty as to the appropriate definition of a social welfare organization in the IRC and Treasury Regulations is apparent from a reading of the texts of the Code and Regulations. As noted above, the regulations that define the term “educational” as a charitable exempt purpose distinguish organizations entitled to be classified as charities under section 501(c)(3) from organizations described as “action” organizations. The regulation explains that the differentiating characteristic is that an action organization is one that conducts substantial lobbying activity, noting that such an organization may be able to qualify for exemption if it is described in Code section 501(c)(4) as a social welfare organization, particularly if it would have otherwise qualified under section 501(c)(3) except for the amount of lobbying it planned to do. In fact, organizations are described in this section of the Code as “civic leagues or organizations not organized for profit but operated *exclusively* for the promotion of social welfare” (italics added). The regulations, promulgated in 1959, start by saying that a civic league or organization will qualify for exemption if it is not organized or operated for profit and “it is operated exclusively for the promotion of social welfare.” However, the regulations then go on to state: “An organization is operated exclusively for the promotion of social welfare if it is *primarily* engaged in promoting in some way the common good and general welfare of the people of the community....The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office”(italics added). In 1981 the IRS issued a revenue ruling in which it held that lawful participation in campaign activity would not affect the 501(c)(4) status of an organization whose primary activity was promoting social welfare. Some individuals have interpreted the language of the regulation, together with this ruling, to mean that up to 49 percent of activities could be devoted to political campaigns, as long as the remaining 51 percent consisted of social welfare activities. Thus, “exclusively” became “primarily,” and the clear statement in the regulations prohibiting campaign activity was ignored.

There is precedent for interpreting “exclusively” to mean “substantially,” as used in the regulations under section 501(c)(3) that distinguish between purposes and activities. According to the Code, the organizations described in that section must be “organized and operated exclusively” for the charitable purposes therein enumerated. Echoing the regulation on the organizational test, the regulation describing the operational test declares that an organization will be operated exclusively for exempt purposes if it engages primarily in activities which accomplish one or more of the exempt

purposes specified in section 501(c)(3). This regulation also clarifies that the test will not be met if more than an insubstantial part of an organization's activities are not in furtherance of an exempt purpose. Thus, unlike the liberal interpretation that has reportedly been applied to social welfare organizations, the substantial test for charities has been considered to mean that between 10 percent and 20 percent of noncharitable activities will be tolerated, but not more. Proposals for reform, several framed before the IRS "scandal" became public, range from repealing section (c)(4) entirely, to defining more clearly either that campaign activity is completely prohibited or is permitted up to a modest amount of expenditure and time, and requiring some amount of disclosure of donors. As of September 2013, it remained unclear what if anything will be done to clarify the law. Although the issue does not now directly affect the legal meaning of charity, consideration of reforms regarding advocacy organizations could affect all charities.

### *Will the Definition of Charity in Federal Tax Laws Continue to Expand, or Will It be Transformed?*

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 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 facing the IRS and the Treasury Department involve business activities of tax-exempt charities, whether their bent is too commercial, whether an entity can be charitable if it relies solely on fees-for-services for revenue, 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, how charitable purposes are carried out (in other words, whether or not they pass the operational test). In 2013, concern with the manner in which the IRS had handled requests for exemption for social welfare advocacy organizations as described above appeared to undermine public confidence in its impartiality, while bringing to light the fact that IRC section 501(c)(4) needed greater clarification, whether by act of Congress amending the Code, or action by Treasury promulgating new regulations. As noted above, any such action by Congress could affect the definition of advocacy organizations, an important distinction in the section of the regulations defining "educational purposes."

Finally, among the tax reform proposals Congress is considering in 2013 are a number that would affect the universe of charitable organizations. As outlined in a June report by the Senate Finance Committee Staff, one goal for tax reform would be to more tightly align tax-exempt status with

providing sufficient charitable benefits. “Theoretically, nonprofit organizations are granted tax-exempt status because they provide a benefit to the public, particularly to the poor and underserved. However, organizations that do not serve the needy can often claim tax-exempt status...” (Senate Finance Committee Staff 2013, 3). Thus, Congress may focus on the broad categories of charities and mete out benefits in accordance with the worth it considers each one is providing to society. If that is the case, the federal tax law of charity could be the subject to a major transformation and, as noted below, the definition of charity under the federal tax laws would for the first time diverge widely from state law.

### *The Legal Definition of Charity in the States*

In order to understand state laws governing charities and defining charitable purposes, one must start with early English common law. In fact, a law of charity was first formulated in England in the 16th century. At the same time as the courts recognized private trusts, 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 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 19th 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 13 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 as of 2013.

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 earlier; these sources include decisions of the federal courts interpreting IRC provisions, as well as state laws where there is a dispute among the states, and state court decisions from all 50 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, sales, and property taxes; and local municipal laws, when authorized by a state constitution or the legislature, affect exemption from property taxes.

As noted at the beginning of this section, 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 English precedents. Therefore, the laws included requirements that charitable organizations benefit an indefinite class, that they do not further private purposes, and that the charities’ purposes could not be illegal or against fundamental public policy.

The currently accepted definition of charitable purposes under state law can be found in the *Restatement of Law, Third, of Trusts*, section 28, which lists 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 falling within 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) charitable purposes 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 September 2013 draft of *Principles of the Law of Charitable Nonprofit Organizations*, being written under the auspices of the American Law Institute,

follows this Restatement formulation with one exception. It changes 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*, particularly the opinion of Justice Powell. In this September 2013 draft, a charity is defined as follows:

- (a) A charity is a legal entity with exclusively charitable purposes, established for the benefit of an indefinite class of beneficiaries, and prohibited from providing impermissible private benefit.
- (b) Charitable purposes include:
  - (1) the relief of poverty;
  - (2) the advancement of knowledge or education;
  - (3) the advancement of religion;
  - (4) the promotion of health;
  - (5) governmental or municipal purposes; and
  - (6) other purposes that are beneficial to the community.
- (c) A purpose is not charitable if it is unlawful, its performance requires the commission of criminal or tortious activity, or it is otherwise contrary to fundamental public policy.

There are also model state statutes, such as those approved by the Commissioners on Uniform State Laws, that define charitable purposes according to 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 by the same group, 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 Law Section of the American Bar Association in 2008, 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 20th century and one that is likely to lead to less litigation than in the past, most of it confined to enforcement of charitable fiduciary duties. One of such duties, the duty of loyalty, requires fiduciaries to carry out the purposes of the organization, and its concomitant—namely, 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. The law reflects 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 *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 19th and early 20th 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 impracticable 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 20th 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. There is also evidence that the courts, usually with the acquiescence of the state attorney general, are more willing to apply the doctrine more liberally than heretofore, by not requiring that new purposes be very closely related to the original ones. The *cy pres* doctrine 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 a widely accepted standard for a long period. 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” (page 556).

The *Jackson* case also validated the cy pres doctrine and affirmed that a trust could not be charitable if a change in the law 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 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” (page 597), 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 legislative and political activity in this case has been followed consistently in the ensuing years and are pertinent today.

A variant of the doctrine of cy pres 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 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 differences 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 outside 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 ownership 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 oversight, and the trustees personally 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 sales proceeds 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 communities.

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. 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 such transactions as mergers, dissolutions, and other 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 scarcity 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 important differences. These differences are most notable in the sanctions applied for failure to comply. In 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' basic 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 income 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. Local authorities (e.g., city or town officials) generally determine exemption from property tax, although the state legislature or constitution must authorize their authority. Litigation in Pennsylvania and Illinois arose at the end of the 20th century over a phrase found in the constitutions of several states, namely that exemption is available to "institutions of purely public charity." In Pennsylvania in 1985, the state 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 state courts differed on the definition 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. The matter remains unsettled in that jurisdiction.

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. As is the case in Pennsylvania, the issues remain unsettled. These cases have been 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 federal 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 participation in any political campaign; (5) a requirement that its assets will always remain devoted to charitable purposes; and (6) a 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 one that 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 a change to the law; (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. The differences between the two, in fact, arise from the nature of federal and state regulation of charities and the sanctions available for violations. The available sanctions under federal law are imposition of excise taxes and revocation of exemption following procedures established by the Treasury under the Internal

Revenue Code applicable to all filers, 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 application of cy pres is appropriate. The regulator is the state's attorney general, who has almost exclusive power to assure protection of charitable assets with the ultimate power to correct abuse residing in the state courts. As a result, 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 Legal Definition of Charity Provides Sufficient Flexibility to Meet Society's Need Today and for the Immediate Future*

The purpose of this paper has been to describe federal and state laws that together can be considered to comprise a legal definition of charitable purposes. In its totality, this is not easily found, although the early drafts of the American Law Institute's *Principles of the Law of Charitable Nonprofit Organizations* have already begun to fill that vacuum, while the *Restatement of the Law, Third, Trusts* contains a now widely accepted definition of charitable purposes and a definitive compilation of the state law cases on this subject. Due to the fact that these purposes of charities are permitted to change over time, the law of charity is unlike 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 congressional staff, look at the Internal Revenue Code provisions and see first, not the amount of dollars lost by virtue of tax exemption, but rather the larger amount lost by virtue of the deductions for donations to charities. They question whether taxes lost to 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 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, could lead to such fundamental changes in the nature of charities that their benefits to society would 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 into it can never be simple or straightforward, because the nature of change does not necessarily follow a straight line.

## *Note*

A number of treatises on the law of charity 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. Halbach, 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.