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The Life Cycle of a Charitable Organization

THIRD EDITION



Nonprofit Law The Life Cycle of a Charitable Organization

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***NONPROFIT LAW:
THE LIFE CYCLE OF A
CHARITABLE ORGANIZATION***

THIRD EDITION

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*To grandchildren, mine and others,
for whose future the nonprofit sector works so tirelessly.*

- ES

*To all the nonprofit organizations that
support family members, mine and others, when they are in need.*

- AM

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PREFACE TO THE THIRD EDITION

In faith and hope the world will disagree, but all mankind's concern is charity.

Alexander the Great

The law of charitable organizations is important. It is also complex. If you are a law student, you are likely to come into contact with charitable organizations at some point in your legal career. Whether you specialize in tax-exempt transactions, work or volunteer for a nonprofit, or serve on a nonprofit board, an understanding of the practical legal issues confronting these organizations will serve you (and your community) well. If you are a public policy or business student who plans to work or volunteer for a nonprofit organization, these laws may be even more important to understand. Few nonprofits can afford to hire lawyers, and yet it is impossible to manage or govern well in this sector without an understanding of the rules that guide the sector.

This casebook covers the unique legal issues that charitable organizations face. It uses the traditional casebook format to cover abstract legal principles, but it also has a practical bent. The book is organized around the life cycle of a §501(c)(3) organization, the type of tax-exempt organization that is often called a “charitable” organization. This book will introduce you to the legal issues that arise when the organization is formed, when it raises funds, while it is operational, and when it either winds down its affairs or transforms into a different organization.

You will be asked to apply the legal principles you learn in a practical setting. Most of the hypothetical questions will put you in the position of an attorney, a judge, or an executive director of a §501(c)(3) organization. The book is also designed so that, if the instructor chooses, students can create, operate, and dissolve a virtual §501(c)(3) charitable organization over the course of the semester. Additionally, this practical approach offers a helpful perspective for clinical courses.

The book is organized into four units. The first, Starting the Nonprofit Organization, introduces the book, explains state law requirements for starting a nonprofit corporation, explores the fiduciary duties for boards of directors, and examines the requirements for obtaining recognition as a §501(c)(3) organization. The second unit focuses on legal issues that arise when the §501(c)(3) organization raises money: charitable contributions, charitable solicitations, foundations and alternatives to foundations, and the law relating to nonprofits’ commercial activity. The third unit, dealing with topics that arise once the organization is fully functional, presents the subjects of inurement and intermediate sanctions, joint ventures and subsidiaries, lobbying and political activity, and accountability. The final unit covers the topics of merger, conversion to for-profit status, and dissolution. Real-world legal issues do not always appear in this order, of course, but this organization offers a cohesive approach to understanding the legal issues. By the time you complete the four units, you should have a solid foundation to understand, reconcile, and act upon the complex issues that will confront you as

you work with any of the hundreds of thousands of nonprofit organizations that inhabit our vibrant civil society.

NEW FOR THE THIRD EDITION

It would be a wild understatement to say, as did the preface of the second edition, “that the political and economic landscape for charities has changed considerably” since that edition was published in late 2016. We are writing this preface in late summer 2020, when Covid-19 is racking the world, a strong racial justice movement is underway, and major financial uncertainty is everywhere. Nonprofits are at the center of this upheaval. They bring humanitarian relief, deliver medical care, and provide leadership for the racial justice movement, all without knowing whether their employees can stay safe or they can continue operations for financial reasons. The laws that you will learn about in this book are designed to help nonprofits govern, whatever their circumstances. These laws will be doubly important as the nonprofit world faces the challenges of 2020 and beyond.

Considering all the change and tumult in the world, nonprofit laws have stayed relatively stable over the past 4 years. The Tax Cut and Jobs Act of 2017 (TCJA) was the most significant federal legislation during that time. Its changes to the standard deduction, the charitable deduction, and the total amounts taxpayers could deduct, have large ramifications for the total amount that is ultimately given to charity. Those changes and their potential repercussions are discussed in Chapter 6, as are the temporary changes to the charitable deduction rules that the Coronavirus, Aid, Relief, and Economic Security (CARES) Act of 2020 introduced.

The TCJA had other provisions that affected the endowments of very wealthy colleges, the unrelated business income tax, and compensation for nonprofit executives. Those changes are discussed in Chapters 4, 8, and 9, respectively. The IRS has promulgated some rules that are mentioned in the notes, but the proposed repeal of the Johnson Amendment, which would have made major changes to nonprofit law, did not come to fruition. This development is part of Chapter 11.

State legislatures and state charitable officials have remained active in the past four years, particularly the states that reacted to provisions of the TCJA Act that affected their constituents. Much of what they did has either been overruled or is too complicated to put into an introductory nonprofit law book, but where relevant, we have explained their activity in the notes throughout the book.

No major appellate cases appeared in the last four years, but a state court case, *New York v Donald J. Trump Foundation*, provides a case study for many of the issues in the book. We reproduced the allegations of the Complaint that dealt with fiduciary duty violations in Chapter 3 and the Order of Dissolution in Chapter 13. The Trump Foundation’s legal woes are mentioned in the notes of other chapters as well.

Politicians of all stripes make at least cameo appearances in this book, and, nonprofit issues relating to Hillary Clinton, Joe Biden, and Michelle Obama are all mentioned in the notes. Other prominent nonprofits that illustrate both the

complexities of this area of the law and the difficulties in enforcing it also appear in this edition. Examples include the National Rifle Association (NRA), which faced allegations of inurement and breaches of fiduciary duty, and the Boy Scouts of America, which filed for bankruptcy. The Key Worldwide Foundation is less well known, but it is the nonprofit that funneled most of the bribery money in the college admissions scandal, and so it provides another case study for this book.

The third edition is reorganized slightly. We shifted the order of Chapters 5 and 6, because we recognize that a nonprofit must solicit funds before it can deal with charitable deductions. We also moved the enforcement part of Chapter 3 to Chapter 12, which deals with enforcement at both the state and federal level. In several places throughout the book, we eliminated third party essays and replaced them with our own. (In one instance, though, we replaced a third-party essay with a more recent one.) We also summarized many of the state law statutes, because they seemed redundant. Finally, we added a few old cases, which provide background for the newer cases that are already part of the book. We introduced *Big Mama Rag v. United States* and *Village of Schaumburg v. Citizens for a Better Environment*, along with the cases in Chapter 2 that we had eliminated in the second edition.

Perhaps the most notable change in this edition of the book, however, is the addition of the co-author, Allen Madison, whose expertise, thoughtfulness, and skills are present throughout.

Overall, we hope that these changes provide the reader with the most up-to-date and relevant explanation of the rules surrounding nonprofit law. We recognize that the readers of this book are the ones who will work to heal the cracks in society that have been revealed since the second edition was published, and we encourage you to use this book to accomplish that task. As the late John Lewis has said, “When historians pick up their pens to write the story of the 21st century, let them say that it was your generation who laid down the heavy burdens of hate at last and that peace finally triumphed over violence, aggression and war.”¹

Elizabeth Schmidt & Allen Madison
January 2021

¹ John Lewis, *Together, You Can Redeem the Soul of Our Nation*, N.Y. TIMES (July 30, 2020).

ACKNOWLEDGMENTS

At the outset, we note that in this casebook, as others do, we have omitted most footnotes as well as case and statute citations without indication. We have bracketed each of the remaining footnotes with the note number in the original.

It takes more than a village to write and update a casebook. We are grateful to everyone that influenced us on this project even if we have failed to mention them here. We especially thank Jordan Jepsen at Aspen Publishing for guiding us through this process and Sara Nies, Casey Dalrymple, Renee Cote, and Tom Daughhetee at Froebe Group.

I (Betsy) would particularly like to thank Allen, as there could be no third edition without him. This edition has also benefitted from the encouragement and help of Satu Zoller, Maureen Turner, Kathy Colon, Katy Maher, and Marcie Muelhke. Even in this third edition, evidence of the help I received in the earlier editions is evident. I'd like to acknowledge again the earlier help from Mark Sidel, Cathy Livingston, Miriam Galston, Jayne Barnard, Linda Smiddy, and Carrie Garber Siegreist. As with the earlier editions, my friends and family deserve special kudos for being good sports when I got obsessed with excise taxes and Forms 990—especially my husband Buzz, whose intellectual brilliance and loving support infuses every paragraph of both this book and the earlier editions. Finally, hundreds of students, many of whose names are used in the hypotheticals, have continued to inspire me and this work.

I (Allen) have many people to thank separately, including Betsy, who gave me the opportunity to work on this edition. Also, thanks to Mallory Schulte, Sam Sharpe, and David Levine for their research assistance directly or indirectly on this edition; Tracy Hummel, Heather McDonald, and Emily Posthumus for their administrative support; Sarah Kammer, Courtney Segota, and Eric Young for their library support. I also thank my wife, DaVida, my son, Lazer, and my mom, Rita, for both inspiring me and putting up with me while I've been working on this project. My students have also influenced and inspired me in this work, but there are too many to name. Finally, thanks to my dad who continues to influence my writing from beyond.

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CHAPTER 1

INTRODUCTION TO THE LAW OF CHARITABLE ORGANIZATIONS

Purposes of this chapter:

- Introduce terminology of and theory about the nonprofit sector
- Consider differences and similarities among the sectors
- Discuss rationales for the sector
- Introduce students to skepticism about the sector

To think about as you read:

Is there a nonprofit organization you would like to start or one with which you are familiar? Does it fit within the definition of a nonprofit presented in this chapter? Is the terminology you are learning helpful to understanding this organization? Do any of the rationales for the nonprofit sector explain its presence as a nonprofit?

I. WHAT IS THE NONPROFIT SECTOR?

Approximately 2 million organizations in the United States consider themselves “nonprofit.” Some are so large that they rival *Fortune* 500 companies in terms of payroll and impact on the economy. Others are so small that all the work is performed by one part-time volunteer. Some are incorporated; others are not. Some take care of the poor; others, such as the PGA, could arguably be said to take care of the rich. This chapter will introduce you to that large and diverse sector, particularly the world of charitable organizations. This section of the chapter defines the sector, introduces terminology, and provides some statistics and historical background. The next sections explore rationales for the nonprofit sector, outline the life cycle of a charitable organization, and introduce a case that begins our examination of nonprofit law.

A. A DEFINITION

What defines a nonprofit organization? Is there a single concept that ties all nonprofits together? Dr. Peter Frumkin has identified three features of nonprofits

with which he attempts to answer this question. Although it is difficult to capture the nonprofit sector with one definition, Dr. Frumkin maintains that nonprofits share three features that help define them.¹ First, nonprofits are noncoercive. In general, nonprofits may not compel citizens to contribute to nor participate in societal endeavors. Second, a nonprofit may not share its profits with its stakeholders. This means that nonprofits may not use the expectation of profit potential to attract investment capital. Third, nonprofits are not subject to direct control by owners or other stakeholders. In other words, the lines of accountability are not well defined.

Their noncoercive nature aligns nonprofits with the business more than government. Nonprofits are operated and funded by willing volunteers because they cannot compel people to participate or donate. Unlike a government, nonprofits must rely on goodwill because they lack the power to levy taxes, imprison lawbreakers, or regulate behavior. Nonprofit and voluntary organizations stand ready to receive, but they demand nothing, which clothes them with a valuable moral high ground.

The second feature—the nondistribution constraint—aligns nonprofits more with government than business. Unlike corporations or other for-profit ventures, nonprofits have no owners to whom profits may be distributed. All revenue is retained to advance the nonprofit’s mission. Accordingly, there is less pressure to cut corners or discontinue less popular services.

The third feature—the lack of clear accountability—sets nonprofits apart from the government and business. Voters hold governments accountable, and shareholders do the same for businesses. Nonprofits serve donors, clients, board members, employees, and communities—none of which may exert complete control over the nonprofit. Funding for many nonprofits comes from both the public and private sector, further muddying the line of accountability. Although boards of directors are often responsible for governing nonprofits, the directors are stewards rather than owners.

B. AN INTRODUCTION TO THE TERMINOLOGY

One of the hallmarks of the nonprofit sector is its terminology—it can be confusing, and laymen often use one term to mean another. The term “tax-exempt,” for example, is not always interchangeable with “nonprofit,” but you will sometimes hear the terms used interchangeably. As budding lawyers, you will need to know the correct terminology and understand how the various components of the nonprofit sector fit together. Following is an introduction to these concepts. They will become more familiar as you progress through the chapters of the book.

The U.S. economy is traditionally divided into three sectors: the government, the for-profit sector, and the nonprofit sector. The nonprofit sector is also sometimes called “the not-for-profit sector,” “civil society,” “the voluntary sector,” “the third sector,” “the independent sector,” and “the nongovernmental

¹ PETER FRUMKIN, ON BEING NONPROFIT: A CONCEPTUAL AND POLICY PRIMER 3-6 (Harvard University Press 2002).

sector.” Although all these terms are technically and legally correct, we will use the term “nonprofit sector” in this book, unless the author of an article or a statute we are discussing has used another term.

“Nonprofit” does not mean that the organization cannot make a profit. Rather, it means that the profit is not distributed to shareholders. That is the “nondistribution constraint” that was described above. State statutes dealing with nonprofits have language that codifies this constraint. Not surprisingly, the state statutes have their own terms for nonprofit organizations. The Virginia statute, for example, calls them “nonstock” corporations; New York speaks of “not-for-profit” corporations, and California regulates “public benefit,” “mutual benefit,” and “religious” organizations.

Within the nonprofit sector are many types of organizations. Not all of these organizations are corporations. They can also be unincorporated associations and even trusts. For reasons discussed in Chapter 2, most nonprofit organizations are corporations, however, and most nonprofit corporations are also tax exempt (i.e., exempt from federal income tax). This does not mean they never pay taxes. They may pay state income taxes, employment taxes, sales taxes, and even unrelated business income taxes, a concept we will cover later in this book.

The two largest categories of tax-exempt organizations are §501(c) organizations and political organizations, such as the Democratic and Republican parties. There are 29 types of §501(c) tax-exempt organizations (sometimes called TEOs). The most common is the §501(c)(3) organization, which will be the main focus of this book. Other important §501(c) categories include §501(c)(4) social welfare organizations, §501(c)(5) labor and agricultural organizations, §501(c)(6) business leagues, §501(c)(7) social and recreational clubs, and §501(c)(8) fraternal benefit organizations.

Section 501(c)(3) organizations have another tax benefit that is not generally available to the other §501(c) organizations²: donations to §501(c)(3) organizations are tax deductible to the donor. We will spend a good deal of time later in this book discussing which organizations should be accorded this special status, but one shorthand that is sometimes used is that these are “public benefit” organizations. Other types of tax-exempt organizations, such as fraternities, labor unions, and business associations, are created for the “mutual benefit” of their members and are often called “mutual benefit organizations.” Like public benefit organizations, mutual benefit organizations are allowed tax-exempt status because they are not designed to make a profit for shareholders. Because they are created for the mutual benefit of their members, however, the tax code does not allow those who provide funding for these organizations to take a charitable tax deduction for their contributions.

Section 501(c)(3) organizations are further divided into two types of organizations—public charities and private foundations. In general, public charities obtain funding from public support—donations, government support, and

² A non-501(c) organization with a program that acts like a §501(c)(3) organization, such as a scholarship fund for orphans of firefighters that is part of a firefighters’ organization, may be able to accept tax-deductible donations for that program.

by charging for their services. Most of the organizations that come to mind when one thinks of nonprofit organizations are public charities—museums, homeless shelters, nonprofit hospitals, and private schools, among others. Private foundations, on the other hand, obtain their funding from a single or a small number of sources. They are often grant-making institutions, such as the Gates Foundation, the Ford Foundation, and the Rockefeller Foundation. Chapter 7 discusses in detail the distinction between these organizations and the different legal rules they must follow.

Figure 1-1
The Nonprofit Organization Universe

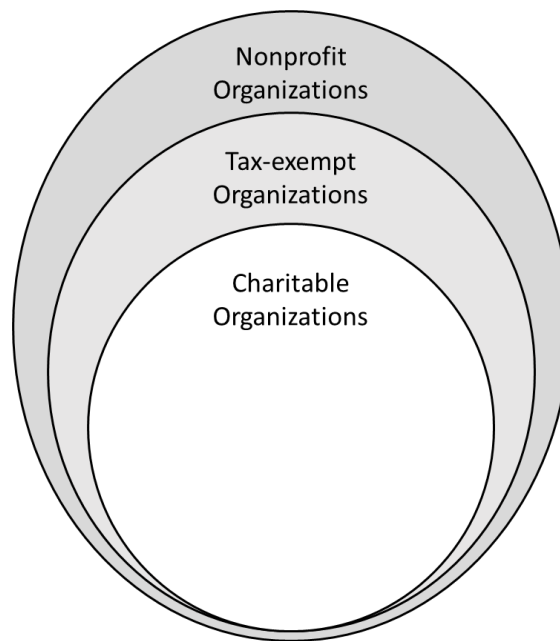


Figure 1-1 depicts the relationships among the organizations defined above.

C. SCOPE OF THE SECTOR TODAY: A FEW STATISTICS

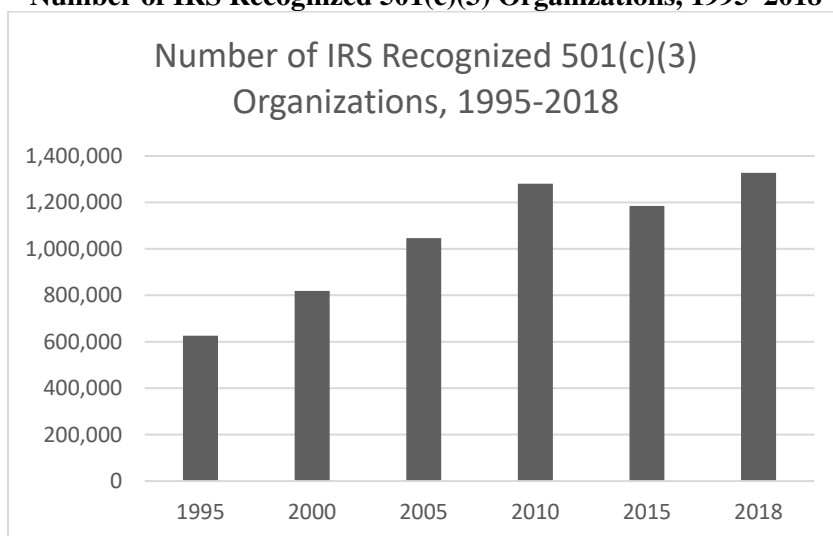
The nonprofit sector is larger than many imagine it to be. In 2016 public charities reported \$2.04 trillion in revenue, \$1.94 trillion in expenses, and \$3.79 trillion in assets. That year the nonprofit sector contributed more than a trillion dollars to the economy and was responsible for 5.6% of the U.S. gross domestic product (GDP).³ The following statistics and charts can give you an idea of the scope of the sector.

³ NCCS Project Team, *The Nonprofit Sector in Brief 2019*, the Urban Institute National Center for Charitable Statistics, accessed July 2, 2020.

1. Number of Tax-Exempt Organizations

The IRS publicizes the number of exempt organizations in the IRS Data Book, Table 14. In 2019, the IRS recognized almost 1.9 million (1,870,666) tax-exempt organizations. Of those, 92% (1,718,233) are §501(c) organizations, and 79% of the §501(c) organizations (1,365,744) are classified as §501(c)(3). Figure 1-2 shows the remarkable growth of the sector over the past 23 years. Despite a downturn that occurred when the IRS began revoking the exemption of §501(c)(3)s that did not file annual tax returns, the number of §501(c)(3)s has more than doubled since 1995.⁴ Most of these organizations are small, however. In 2016, two-thirds of public charities had annual expenses of less than \$500,000, and only 5.4% of charitable organizations had annual expenses above \$10 million.⁵

Figure 1-2
Number of IRS Recognized 501(c)(3) Organizations, 1995–2018



2. Information Forms Filed and Examined

Following are the numbers of information forms filed by tax-exempt entities and examined by the IRS in 2019.⁶

⁴ The 2018 data in the paragraph and the chart are from IRS DATA BOOK 2018, Table 14, <https://www.irs.gov/pub/irs-pdf/p55b.pdf>, accessed July 2, 2020. The numbers in the chart from earlier years are from earlier IRS Data Books. These numbers do not include certain §501(c)(3) organizations that need not apply for recognition of exemption, such as churches, integrated auxiliaries of churches, and organizations with normal gross receipts in each taxable year of \$5,000 or less. In 2010, the IRS revoked the exemptions of more than 300,000 §501(c)(3)s for failure to file annual tax returns. That change was reflected in the 2011 statistics and explains the downturn after 2010.

⁵ NCCS Project Team, *supra* note 3.

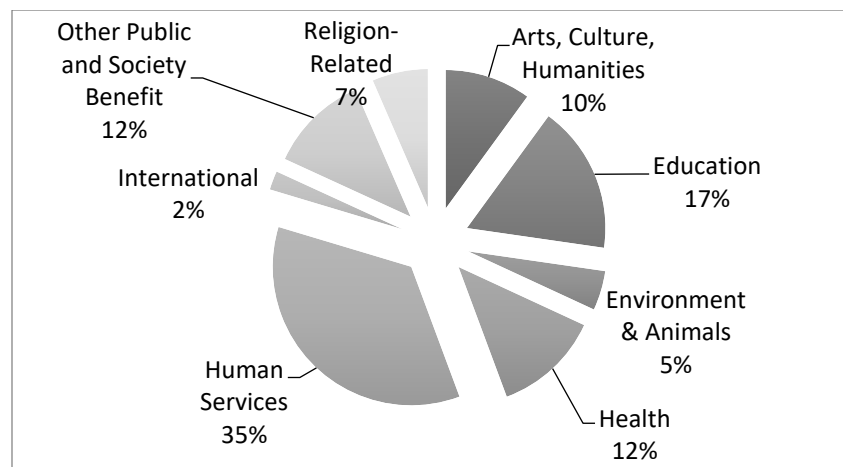
⁶ IRS Data Book 2019, Table 2; IRS Data Book 2019, Table 21.

Tax exempt returns filed FY 2019: 1,590,421
Tax exempt returns examined FY 2019: 13,433
Forms 990, 990-EZ, and 990-N examined FY 2019: 1,335

3. Classification of Tax-Exempt Organizations

To capture the diversity of nonprofit organizations in the United States, the National Taxonomy of Exempt Entities includes over 630 categories that group organizations under eight major headings.⁷ Figure 1-3 shows the number of §501(c)(3) public charities classified within each of these major categories in 2016.⁸

Figure 1-3
Registered Public Charities by Major Purpose or Activity, 2018



4. Employment in the Nonprofit Sector

In 2016, the nonprofit sector in the United States employed 12.3 million workers and paid out \$638 billion in wages. The nonprofit sector accounted for 10.3% of the private workforce, with approximately as many employed in this sector as in the manufacturing sector.⁹

Employment in the nonprofit sector has proven to be quite resilient. Between 2007 and 2016, the nonprofit workforce increased by 16.7%. The for-profit workforce, which was hit by a deep recession in the early years of that decade, grew by 4.6% during that time.¹⁰ Undoubtedly, this disparity occurred because

⁷ Statement of Elizabeth Boris, Ph.D., Director, Center on Nonprofits and Philanthropy, the Urban Institute, Testimony before the Subcommittee on Oversight of the House Committee on Ways and Means, Serial 110-60, Sept. 25, 2007.

⁸ The statistics for the figure are from THE NONPROFIT SECTOR IN BRIEF 2019 *supra* note 3.

⁹ Lester Salamon and Chelsea Newhouse, The Johns Hopkins Center for Civil Society 2019 *Nonprofit Employment Report* (2019).

¹⁰ *Id.*

nonprofit jobs tend to be in service industries, such as health care and education, which are growing areas of the economy. Jobs in areas that are declining, such as manufacturing, are rarely found in the nonprofit sector. One area of concern, however, is that for-profit companies are moving into the service industries and are capturing some of the market share. The percentage of people employed in the nonprofit sector, as opposed to the for-profit sector, declined between 2007 and 2016 in the fields of education, hospitals, nursing homes, and social services. Most dropped one or two percentage points but the social assistance field dropped fairly precipitously. In 2006, nonprofits held 56.9 % of the jobs in that field, a figure that dropped to 42.35% in 2016.¹¹

In addition to paid jobs, the nonprofit sector “employs” millions of volunteers. In 2017, 64.4 million Americans, or approximately a quarter of the population, volunteered. These volunteers contributed 8.8 billion hours of service in 2017, which had an estimated value of \$195 billion.¹²

5. Charitable Contributions

Charitable giving in the United States usually hovers around 2 percentage points of GDP. In 2019, for example, charitable giving amounted to \$449.64 billion, which was 2.1% of GDP. That was an increase over 2018, which surprised some observers who had worried that the 2017 tax bill created disincentives for charitable contributions. Figures 1-4 and 1-5 shed more light on charitable contributions made in 2019 by illuminating by sources of gifts and the recipients of these gifts.¹³ Figure 1-6 reveals the sources of all revenues, including charitable gifts, as reported in the December 2019 Business Master File.¹⁴

¹¹ *Id.*

¹² Nonprofit Sector In Brief 2019, *supra* note 3.

¹³ The information in this paragraph and for Figures 1-4 and 1-5 is from GIVING USA, 2020, GIVING USA FOUNDATION.™

¹⁴ Anna Koob, *Five Things That Didn't Make It Into the Latest Key Facts*, CANDID NEWSLETTER (June 2, 2020) (statistics based on Candid's analysis of Form 990 filings).

Figure 1-4
2019 Contributions by Source

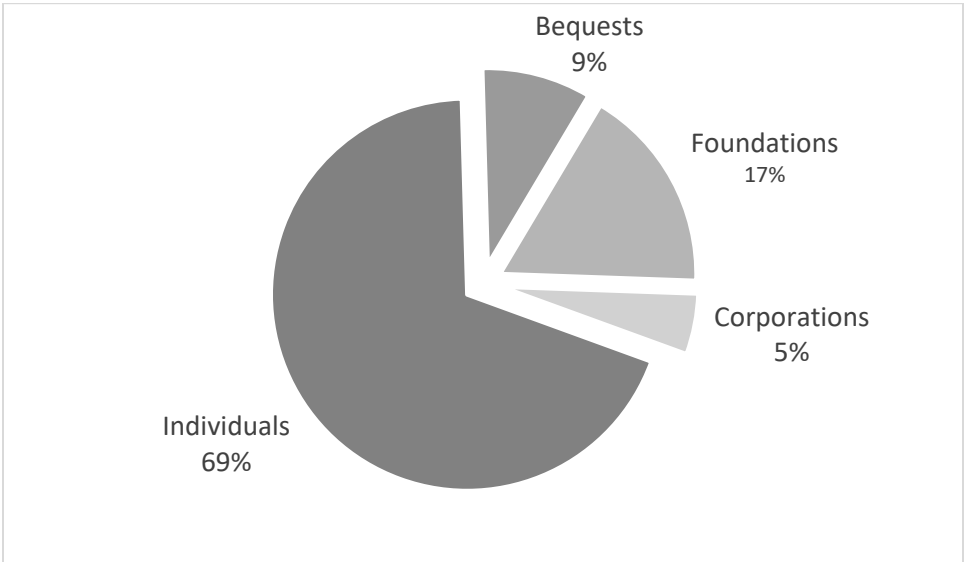


Figure 1-5
2019 Contributions by Type of Recipient

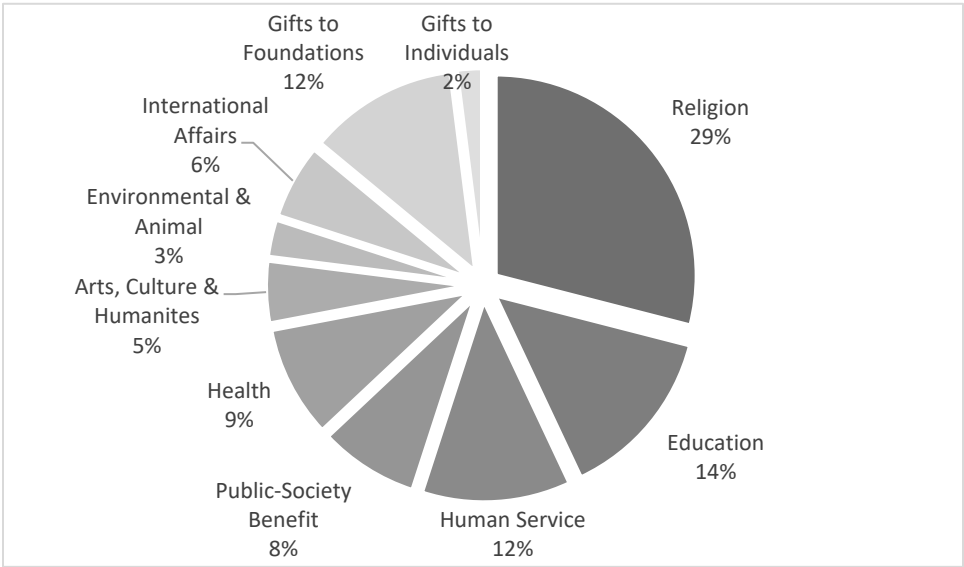
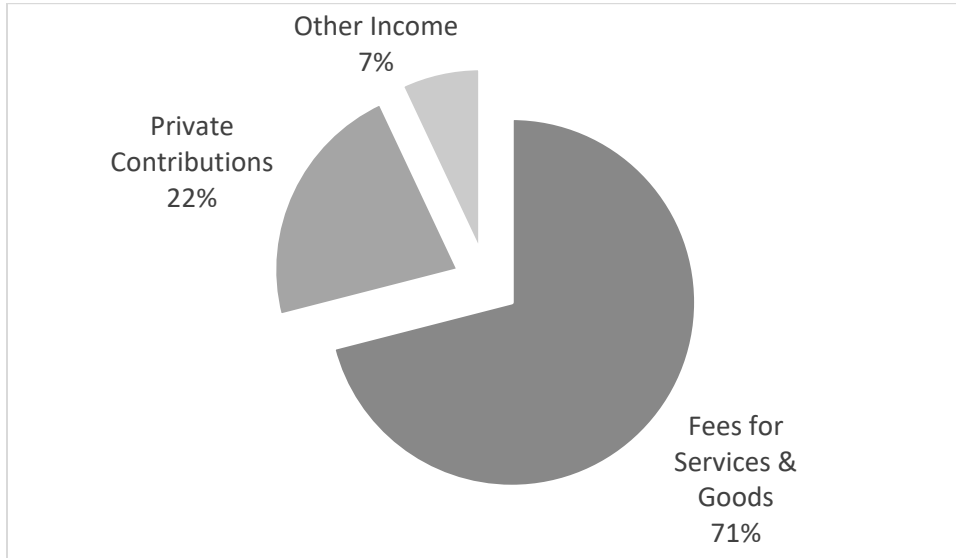


Figure 1-6
Sources of Revenue for Reporting Charities, 2019 IRS Business Master File



NOTES AND QUESTIONS

1. Compare the number of organizations in each subsector of the nonprofit sector (Figure 1-3) with the amount of resources that each subsector receives (Figure 1-5). Should the legal system do anything to encourage a reallocation of those resources?
2. Did it surprise you that private foundations and corporations provide such a small percentage of contributions or that contributions provide such a small percentage of nonprofits' revenues? Would you prefer that either of these facts be different? If so, would you suggest that we have laws that encourage a change or that we allow the free market to determine how nonprofits receive their resources?

D. HISTORICAL BACKGROUND

Religious Origins and Early Versions of Nonprofits

Charity has always been an essential component of the world's religions. Ancient Egyptians were buried with records of the "blessed givings" that they had shared with the poor during their lifetimes. Buddhism, founded in 400 B.C., taught that love and charity were important virtues. Hindu scriptures stressed the duty to give to the needy. Early Jewish doctrine also taught that humans have a moral

obligation to aid those in need. And early Christianity taught that people should love their enemies, practice good deeds, and offer alms generously.

By the sixth century, Catholic monasteries were centers for relieving poverty, tending the sick, and providing education—early versions of nonprofit organizations. In the seventh century, the Prophet Mohammed recommended setting aside a piece of land and using its revenues to aid the poor. This practice, called the *waqf*, is the Islamic equivalent of the charitable foundation, and it helped create early hospitals, orphanages, schools, and religious institutions. The use of the *waqf* remains prevalent in the Islamic world.

As the Middle Ages arrived in Europe, landed nobles began to take responsibility for caring for their needy subjects in exchange for loyalty, labor, and a willingness to fight for them. Cities, towns, and guilds also began to take care of the poor, but monasteries remained primary vehicles for charity. In fact, in the thirteenth century, papal decrees encouraged individuals to donate to charitable or religious purposes. The price for failure to follow this norm was eternal damnation.

The Statute of Charitable Uses Act from 1601 is generally considered the first secular—and written—charitable law in England. It is the basis of all subsequent Anglo-American charity law. It attempted to define the concept of charity as a way to encourage private charitable efforts.

The Early Years of the United States

But tax considerations were unimportant in the fledgling United States because there was no federal income tax. Nor were there separate governmental, business, and nonprofit sectors of the economy. In the early days of the republic, state legislatures chartered all governmental entities, charities, and businesses as “corporations.” They only granted corporate charters to those that served a public purpose. Thus, most of the corporations then were cities, towns, and other governmental units. A small fraction would be called “for-profits” today, and the rest were religious, educational or charitable in nature.

The Federal Income Tax and Changes in the First Half of the 20th Century

When Congress enacted the first federal income tax in 1913, charitable organizations were exempted. The list of charitable purposes that would allow an organization to be recognized as tax exempt was remarkably similar to the list in the Statute of Uses from 1601. It was also similar to the purposes you will learn about in Chapter 4.¹⁵

¹⁵ The 1913 version was based on laws that had been passed in 1894 and 1901 and then revoked or overturned, and additional purposes were added in 1918 and 1921. The 1913 date is used because the United States has had a federal income tax, with a charitable exemption, continuously since that date. See Joint Committee on Taxation, HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL EXEMPTION FOR CHARITIES AND OTHER EXEMPT ENTITIES (House Ways and Means

The charitable deduction benefit, which is covered in Chapter 5, was added for individuals in 1917 and for corporations in 1936. Restrictions on lobbying and a prohibition on intervention in political campaigns, both of which are discussed in Chapter 11, began in 1934 and 1954, respectively.

Since that time, charitable organizations' fortunes have risen and fallen, largely in conjunction with those of the economy. During the Gilded Age and the first few decades of the 20th century, when corporations and their owners grew increasingly rich, philanthropy blossomed. The tycoons of that era created large grant-making foundations, which are discussed in Chapter 7. Many of those early foundations continue to this day.

Later, when the Depression hit and the New Deal was introduced, the government began working with charities to solve social problems, another practice that exists to this day. And during the managerial, bureaucratic heyday of the American corporation of the 1950s and 1960s, nonprofits fared well because they received the largesse of civic-minded corporations.

Statutory Changes in the Second Half of the 20th Century

Major changes in U.S. charity law occurred in 1950, 1969, and 1996. By 1950, many nonprofit organizations competed directly with for-profit organizations. NYU Law School, for example, ran a large macaroni company and owned Limoges China, neither of which paid income taxes. Congress introduced the Unrelated Business Income Tax that year in order to equalize the tax consequences between purely commercial businesses and those nonprofits with commercial activities that competed with these businesses. This Unrelated Business Income Tax, which is covered in Chapter 8, began what Professor Henry Hansmann has called “a broad retreat from the consistently favorable treatment that nonprofits had come to enjoy.”¹⁶

In 1969, Congress created the distinction between public charity and private foundations. Private foundations receive funding from a single source or from a small number of sources, and they generally use that money to make grants to other charities. This shelters them from a broad cross-section of the public and makes accountability problematic. In contrast, multiple donors, government grant-making institutions, and purchasers are involved with funding public charities, which makes them more visible and more organically accountable.

Prior to creating this distinction, wealthy individuals could legally take advantage of the fact that their private foundations were not exposed to broad section of the general public to get around the tax laws. For example, a wealthy individual could get the tax benefit of donating money to a private foundation and

Committee, Apr. 20, 2005). Additional information on the history of philanthropy can be found in Olivier Kunz, *HISTORY OF PHILANTHROPY IN AMERICA* (Princeton University Press 2012). See also HISTPHIL, a blog dedicated to the history of philanthropy, which helps bring into context many of today's nonprofit issues. <http://histphil.org>, last accessed Jan. 27, 2019.

¹⁶ Henry Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807, 814 (1988).

then use the resources of the private foundation for personal gain. A wealthy individual could also theoretically fund a private foundation with corporate stock and shelter the business from income taxation instead of running it as a for-profit business. Further, that wealthy individual could use the private foundation as a tax-free investment vehicle, and even use a private foundation as a place to park personal wealth for use by family in future generations. As we will see in Chapter 7, Congress decided in 1969 to increase regulations on private foundations in order to address these issues.

The last major legislative change in nonprofit law came in the late 1990s, when Congress passed an “intermediate sanctions” law designed to strengthen the rules that individuals could not personally profit from a nonprofit. Previously, the remedy for abusing the nondistribution constraint was revocation of exemption for the nonprofit, a remedy that proved inadequate when the CEO of the United Way of America, then the largest charity in the United States, was found guilty of financial mismanagement and fraud. No one wanted the United Way to lose its exemption, but they didn’t want to encourage wrongdoing, either. Once the new sanctions were in place, the wrongdoer(s) had to pay a penalty for their illicit actions, either in addition to or in place of revocation of exemption for the §501(c)(3).

More Recent Trends

The distinction between private foundations and public charities was made just as a new era of business was beginning, one that increased the emphasis on profits for the shareholders. This era has created some very wealthy people who have often been quite philanthropic. Bill Gates and Warren Buffet, for example, have combined philanthropic efforts through the Gates Foundation, the largest foundation in the world. But wealthy individuals no longer automatically use the nonprofit sector for their charitable endeavors. Mark Zuckerberg and Priscilla Chan, for example, have used a for-profit vehicle, the LLC, for their philanthropy.¹⁷

Wealthy individuals have also increasingly placed their charitable funds in a nonprofit mechanism called donor-advised funds, which are often housed in the charitable arm of large investment houses. Critics worry that these funds perform the same functions as private foundations without the private foundation regulations, and that they are ripe for abuse. We will explore that dispute in Chapter 7.

This era of increased wealth has also seen a rise in mega-gifts, which in turn has led critics to ask if these large gifts give donors too much power over the way social and environmental issues are handled. They argue that those issues should rightfully be decided by voters. At the same time, middle class donors are disappearing, and many worry that the 2017 Tax Cut and Jobs Act, which

¹⁷ The book discusses this trend in Chapters 2 and 7.

dramatically lowered the number of people who would have an incentive to take a charitable deduction, only exacerbated that trend.

Finally, this era of increased wealth has also created unprecedented levels of income inequality and a need for more social services. As described above, the number of §501(c)(3) organizations has more than doubled since 1995. And yet government support of nonprofits has also shrunk during this time, and the gap between donations and operating expenses has grown for many organizations. As a result, charitable organizations increasingly look to commercial endeavors to help bridge the gap, a phenomenon discussed in Chapters 8 and 10. This development has some experts questioning whether traditional distinctions between for-profits and nonprofits should still exist, particularly because many for-profit businesses are beginning to recognize the need to be more socially responsible.

Thus, the role of nonprofits in our society remains fluid, and we continue to ask whether our existing rules for nonprofits are sufficient to handle the issues that arise. We will ask these questions throughout the book, but this is also a good segue to a discussion on nonprofit theory, which follows in the next section.

II. RATIONALES FOR THE NONPROFIT SECTOR

Why do we have a nonprofit sector? How is a nonprofit organization different from a for-profit or governmental organization? Following are descriptions of economic, political, and social theories that try to answer these questions. As we will see, these theories overlap, and yet none completely explains the existence of the nonprofit sector. We will encounter similar difficulties when we look for theories to explain tax exemption and the charitable tax deduction. Does this difficulty mean that we have defined the sector incorrectly? Should we accept one theory in some circumstances and another in other circumstances? As you learn about and discuss the laws surrounding the nonprofit sector, you will have the opportunity to consider whether the lack of a single coherent theory creates a somewhat inconsistent legal framework. You will also be able to see that most, if not all, laws have their roots in at least one of these theories.

A. ECONOMIC THEORY

Economic theories posit that nonprofit organizations emerge when a “market failure” exists. In general, markets work well to help us determine how much to produce and distribute of “private goods,” those items that we ordinarily buy and sell in the for-profit marketplace, such as consumer items. Markets do not work, however, for “public goods”—goods that cost the same to produce for one person as for many people and for which no easy mechanism exists to prevent others from accessing these goods once one person has access to them. Public goods include military protection and clean air. It is difficult to set a price for such items because, once one person has access to them, others will gain access without payment. They become “free riders.”

The government can avoid this “free rider” problem if it produces and distributes these public goods because it can coerce the payment of taxes. The government does provide many of these public goods, such as military protection and roads. But the government is constrained by the voters, and it can provide only as much in the form of public goods as the majority of American voters support.

Inevitably, a minority of Americans see more merit in these public goods than the average voter, and they are willing to fund more of whatever public good is not being produced by the government. For example, citizens of a neighborhood for whom the city cannot afford to pave the streets may be willing to pave the neighborhood roads themselves. And citizens who suffer from a rare disease will undoubtedly see more of a need to fund medical research into that disease than the average voter. They, their friends, and those they can convince of the importance of medical research for this particular disease may well join forces to create a nonprofit devoted to studying this disease. Thus, the nonprofit sector becomes a private response to instances of “market failure” and “government failure.”

Henry Hansmann has refined this “public goods” theory with the “contract failure” theory. He maintains that nonprofits typically arise in situations in which the consumers do not have adequate information to judge whether they are receiving the quantity and quality of the service they are purchasing. For example, donors sending funds abroad in order to advance international development cannot ordinarily judge whether these funds actually reach their destination. Donors to listener-supported radio cannot determine whether the other listeners are paying as much for the broadcasts as they are. And children in daycare or hospital patients may be unable to explain whether they are receiving quality services. In such situations of asymmetrical information, a for-profit firm has both the incentive and the opportunity to provide inadequate service. Nonprofit organizations do not face these temptations, due to the nondistribution constraint, which disallows distributions of the nonprofit’s profits. Thus, those paying for these services may well prefer to engage with a nonprofit organization because they trust nonprofit organizations to provide the services that they say they will provide.

These “failure” theories look at the demand side of the equation by examining the needs that nonprofits address. Other theorists have looked at the supply side and have developed what are called “entrepreneurship” theories. These theorists suggest that nonprofits do not always simply fill in the gaps left behind by businesses and governments. Instead, these are institutions infused with the moral and philosophical values of their founders. These founders are primarily motivated by abstract, values-based concerns, such as faith or social justice. The nondistribution constraint, and even the provision of services, are secondary to these values. Thus, instead of filling in gaps left by businesses and the governments, nonprofits serve to maximize the values of the founders and their followers.

B. POLITICAL THEORY

Political scientists look at nonprofit organizations from the point of view of their relationship with the government and their role in supporting democracy.

According to political scientists, both governments and nonprofits produce public goods, but the private groups do not face the same constraints that the government does. Most obviously, nonprofits have no need to please the majority of voters, and this freedom from the average voter allows nonprofits to carry on different functions from the government.

For example, nonprofits can accommodate the diversity of values, beliefs, and practices that exist within a democracy. The nonprofit sector can accommodate right-leaning and left-leaning groups, denominational schools, and groups that celebrate a specific ethnic minority group. As such, they help encourage a pluralistic society and allow people who might otherwise feel marginalized to feel part of the democracy. Nonprofits' ability to move more quickly than the government can also make them seem warmer and more humane.

Nonprofits can also engage in experimentation and incur much greater risk than a government can afford to take with public funds. It is sometimes said that the nonprofit sector provides the research and development for society. A program that works well may eventually be adopted by the market sector if it can be monetized, and by the governmental sector if it produces a public good for a majority of the population.

Finally, nonprofits provide freedom from the bureaucracy that necessarily accompanies governmental efforts. Governments must ensure that they treat all their citizens equally, and they create policies and procedures in order to document this equal treatment. Nonprofits do not treat their stakeholders unfairly, of course, but they are generally smaller and less in need of bureaucratic protection. Additionally, nonprofit supporters voluntarily contribute their time and money and can withdraw their support if they witness unfair treatment of themselves or of other nonprofit stakeholders. This watchdog function can take the place of bureaucratic policies and procedures and allow the nonprofit to address the issue more efficiently.

C. SOCIOLOGICAL THEORY

Sociological theorists, who examine the relationships of people between and among groups, consider nonprofits as “mediating institutions” that provide a buffer between individuals and larger bureaucracies, such as the government. Nonprofits help build community and allow communities to solve their own problems.

One way individuals deal with the larger society is to create their own associations or community. When individuals see a social need, they simply band together to fill that gap, as de Tocqueville noted. We see this in political advocacy groups, nonprofits that care for others such as daycare centers and nursing homes, and in mutual interest groups, such as book clubs and groups supporting a particular ethnic or cultural group. Nonprofits can also serve a role in socializing individuals, reinforcing values and creating bonds of trust. As Lester Salamon has pointed out, they embody the quintessential American values of individualism and solidarity. As such, they reinforce both roles, and they help Americans to take the

initiative to promote their own well-being while advancing the well-being of others.¹⁸

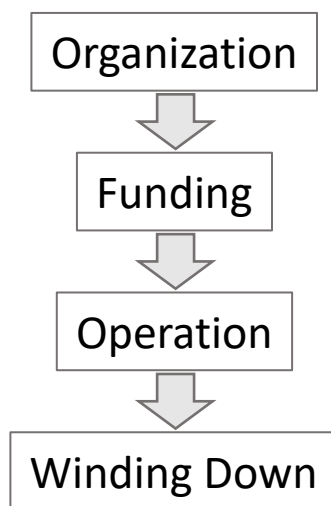
NOTES

1. The description of the theoretical basis for the nonprofit sector above is drawn from Henry Hansmann, *Economic Theories of Nonprofit Organizations*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK*, ed. W. Powell (Yale Univ. Press 1987), pp. 28-31; James Douglas, *Political Theories of Nonprofit Organizations*, in *id.*, p. 44; Steven Rathgeb Smith and Michael Lipsky, *Nonprofit Organizations and Community*, in *THE NATURE OF THE NONPROFIT SECTOR*, ed. J. Steven Ott (Westview Press 2001), pp. 253-255; Michael Worth, *UNDERSTANDING NONPROFIT MANAGEMENT*, 4th ed. (Sage Publications 2016), pp. 50-56; Helmut K. Anheier, *NONPROFIT ORGANIZATIONS: THEORY, MANAGEMENT, POLICY*, 2d ed. (Routledge 2014). *See also* Elizabeth Castillo, *A New Theory of U.S. Nonprofits in a Democracy Gone Awry*, *NONPROFIT QUARTERLY* (May 9, 2019).
2. Lester Salamon has developed a “voluntary failure” theory that contrasts with the market and governmental failure theories described above. Instead of seeing the nonprofit sector as a residual response to failures in other sectors, he argues that the nonprofit sector is the preferred method for providing collective goods. The government is actually the residual sector that compensates for the shortcomings and failures of the nonprofit sector, such as when it cannot raise sufficient funds to fulfill a social need. Lester M. Salamon, *PARTNERS IN PUBLIC SERVICE: GOVERNMENT-NONPROFIT RELATIONS IN THE MODERN WELFARE STATE* (Johns Hopkins Univ. Press 1995), pp. 44-49.

III. THE LIFE CYCLE OF A §501(c)(3) ORGANIZATION

The life cycle of the §501(c)(3) organization is covered in four units that cover the issues raised when one begins a §501(c)(3) organization, when one is raising money for that organization, when one is running the organization, and when the organization is dissolving, merging into another organization or becoming a for-profit organization. In graphic form, the life cycle looks like the following:

¹⁸ Lester Salamon, *The Resilient Sector: The State of North America* (Brookings Institution Press 2003), p. 14.



Organizing a nonprofit involves a number of issues. We'll cover whether to organize a nonprofit in the first place and then discuss organizing the nonprofit with the objective of satisfying the requirements to become a charitable organization under §501(c)(3). The first requirement is that the nonprofit is a valid state entity. As the most common choice is the nonprofit corporation, we will cover legitimate state level purposes for a nonprofit corporation and the governance of a nonprofit corporation. The second requirement under §501(c)(3) is that the purpose of the nonprofit has to be one of the purposes enumerated in the statute. These requirements comprise the first unit.

The second unit covers raising money. The first hurdle in raising money is the state regulation of soliciting donations. On occasion, states have imposed restrictions on soliciting donations that exceeded their authority under the First Amendment. On the other hand, difficulty in enforcement makes it is challenging to prevent large-scale fraud in the tax-exempt arena. The second hurdle raising money is ensuring that contributions qualify for the charitable deduction under §170. There are also different vehicles for charitable contributions. Public charities and private foundations are very different animals. There are other alternatives as well, such as private operating foundations and donor-advised funds. The third issue in raising money is funding from commercial activity. An organization could have so much commercial activity unrelated to its charitable mission that it loses its exemption. If the commercial activity unrelated to the charitable mission is not so excessive that the organization loses its exemption, however, the income is subject to unrelated business income tax.

The third unit addresses issues arising while operating a charitable organization. Charitable organizations have to steer clear of providing commercial or private benefits to stakeholders. Doing so may cause a charitable organization to lose its tax exemption. Revoking an organization's tax exemption is a harsh consequence. As a result, less harsh consequences have developed, such as

intermediate sanctions, involving excise taxes rather than termination.

Another issue in operating a tax-exempt organization is whether to engage in a complex business form. Sometimes an organization decides to bifurcate the operations by forming a subsidiary. A related organization, whether it is for-profit or nonprofit, can be formed in a brother-sister relationship or a parent-subsidiary relationship. This bifurcation can occur because a nonprofit wants to separate its fundraising organization from its operations or it may be important for a for-profit subsidiary to earn unrelated business taxable income. The other complex business form occurs when nonprofits and for-profits join together to create joint ventures. As we will see, charitable tax-exempt organizations engaging in business ventures with for-profit organizations need to structure these arrangements carefully so that they ensure the charitable purpose remains paramount.

A third issue is politics and advocacy. Charitable organizations can engage in unlimited educational advocacy and in some lobbying as long as it is not substantial. But they strictly are prohibited from being engaged in political campaigns.

A fourth operating issue is accountability. Both state charity officials and the IRS regulate charities, and the sector also has mechanisms for self-regulation. The tool the IRS uses for holding charitable organizations accountable is the “tax” information return, the Form 990. A careful examination of that form allows one to see how the IRS takes account of most of the issues discussed in this book.

The final unit of the book discusses end of life issues for charitable organizations. A charitable organization may reach its demise by dissolution, merger, or conversion to a for-profit organization. One question that arises is whether assets distributed to another organization in a merger or conversion retain their original charitable purpose. Another issue arises if solvency is the problem and the nonprofit avails itself of bankruptcy protection. The remaining issues involve the different rules applicable to each type of life-ending event—dissolution, merger, and conversion.

IV. ANATOMY OF A NONPROFIT CASE

Before exploring the substantive legal framework for the nonprofit sector, we will go through a case examining it for what it tells us about nonprofit law generally rather than the substantive law of the case. This particular case is typical in many ways, but the writing is exemplary. Cases discussed in Chapter 4 cite this case extensively.

BIG MAMA RAG, INC. V. UNITED STATES

631 F.2d 1030 (D.C. Cir. 1980)

MIKVA, Circuit Judge:

Plaintiff, Big Mama Rag, Inc. (BMR, Inc.), appeals from the order of the court below granting summary judgment to defendants and upholding the IRS’s

rejection of plaintiff's application for tax-exempt status. Specifically, BMR, Inc. questions the finding that it is not entitled to tax exemption as an educational or charitable organization under section 501(c)(3) of the Internal Revenue Code, 26 U.S.C. §501(c)(3) (1976), and Treas. Reg. §1.501(c)(3)-1(d) (2) & (3) (1959). Appellant also challenges the constitutionality of the regulatory scheme, arguing that it violates the First Amendment and the equal protection component of the Fifth Amendment and that it unconstitutionally conditions tax-exempt status on the waiver of constitutional rights.

Because we find that the definition of "educational" contained in Treas. Reg. §1.501(c)(3)-1(d)(3) is unconstitutionally vague in violation of the First Amendment, we reverse the order of the court below.

[Editor's Note: The issue as described above involves the IRS's denial of an exemption by rejecting BMR's application for an exemption. This is one of two ways the IRS challenges a federal tax exemption. The other challenge occurs in the form of revoking an organization's exemption after it has commenced operations. A rather large percentage of the cases in this book are exemption rejection and revocation cases.]

I. Background

BMR, Inc. is a nonprofit organization with a feminist orientation. Its purpose is "to create a channel of communication for women that would educate and inform them on general issues of concern to them." App. 76. To this end, it publishes a monthly newspaper, Big Mama Rag (BMR), which prints articles, editorials, calendars of events, and other information of interest to women. BMR, Inc.'s primary activity is the production of that newspaper, but it also devotes a considerable minority of its time to promoting women's rights through workshops, seminars, lectures, a weekly radio program, and a free library.

BMR, Inc. has a predominantly volunteer staff and distributes free approximately 2100 of 2700 copies of Big Mama Rag's monthly issues. Moreover, the organization has severely limited the quantity and type of paid advertising. As the district court found, BMR, Inc. neither makes nor intends to make a profit and is dependent on contributions, grants, and funds raised by benefits for over fifty percent of its income. 494 F. Supp. 473, 476 (D.D.C. 1979).

[Editor's Note: The level of support from contributions, grants, and fundraising benefits would make this organization a public charity rather than a private foundation if it qualifies for the charitable exemption. See Chapter 7.]

Because of its heavy reliance on charitable contributions, BMR, Inc. applied in 1974 for tax-exempt status as a charitable and educational institution.¹⁹ That request was first denied by the IRS District Director in Austin, Texas, on the ground that the organization's newspaper was indistinguishable from an "ordinary

¹⁹ [FN2] Tax-exempt status is desirable for two reasons: the profits of exempt corporations are not subject to federal income tax, 26 U.S.C. § 501(a) (1976); and contributions to the organization are tax deductible, 26 U.S.C. § 170(c) (1976). Appellant, which does not expect to make a profit and is heavily subsidized by contributions, seeks tax-exempt status for the second reason.

commercial publishing practice.” After BMR, Inc. filed a protest and a hearing was held in the IRS National Office, the denial of tax-exempt status was affirmed on three separate grounds:

1. the commercial nature of the newspaper;
2. the political and legislative commentary found throughout; and
3. the articles, lectures, editorials, etc., promoting lesbianism.

[Editor’s Note: The IRS District Directors referred to above do not exist anymore in the IRS hierarchy. The initial determination on an application review now comes from the IRS’s Tax Exempt/Government Entities (TE/GE) Division. It should also be noted that the “protest” the organization filed was for an internal appeal of the initial determination. *See* Allen D. Madison, *The IRS’s Tax Determination Authority*, 71 TAX LAW. 143, 168-72 (2017).]

To enable BMR, Inc. to obtain judicial review of the IRS decision, the IRS District Director issued a final determination letter, which denied tax-exempt status on the grounds that, *inter alia*, the content of BMR was not educational and the manner of distribution was that of ordinary commercial publishing organizations.

Appellant then brought a declaratory judgment action in the District Court for the District of Columbia.²⁰ On cross-motions for summary judgment, the judge granted appellees’ motion. Although the court rejected appellees’ argument that BMR, Inc. was not entitled to tax-exempt status because it was a commercial organization, it agreed that appellant did not satisfy the definitions of “educational” and “charitable” in Treas. Reg. §1.501(c)(3)-1(d)(2) & (3). The court found no constitutional basis for disturbing the IRS’s decision.

[Editor’s Note: This is a federal district court case. The IRS’s determination regarding a tax exemption, whether it is the rejection of an application or the revocation of an existing exemption, can also be challenged in either the U.S. Tax Court or the U.S. Court of Federal Claims. *See* ALLEN D. MADISON, *FUNDAMENTALS OF FEDERAL TAX PROCEDURE AND ENFORCEMENT* 625-627 (2019) (discussing the different forums for tax litigation).]

II. The Regulatory Scheme

Tax exemptions are granted under section 501(c) of the Internal Revenue Code to a variety of socially useful organizations, including the charitable and the educational.²¹ The Code forbids exemption of an organization if any part of its net

²⁰ [FN5] *See* 26 U.S.C. § 7428 (1976) (providing for declaratory judgment action in federal district court for determination of tax-exempt status).

²¹ [FN6] Section 501(c) provides in relevant part:

The following organizations are referred to in subsection (a) (which grants exemption): . . .
 (3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

earnings inures to the benefit of private persons or if it is an “action organization”—one that attempts to influence legislation or participates in any political campaign. Treasury regulations impose additional requirements: exempt status is accorded only to applicants whose articles of organization limit their activities to furtherance of exempt purposes (the “organizational test”) or whose activities are in fact aimed at accomplishment of exempt purposes (the “operational test”). Treas. Reg. §1.501(c)(3)-1(b) & (c) (1959).

[Editor’s Note: The above summary is great because it incorporates the “organizational test” where the IRS may reject an application and the “operational test” where the IRS may revoke an existing exemption.]

The Treasury regulations also define some of the exempt purposes listed in section 501(c)(3) of the Code, including “charitable” and “educational.” The definition of “educational” is the one at issue here:

The term “educational,” as used in section 501(c)(3), relates to—

- (a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or
- (b) The instruction of the public on subjects useful to the individual and beneficial to the community.

An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.

Treas. Reg. §1.501(c)(3)-1(d)(3)(i) (1959).

The district court found that BMR, Inc. was not entitled to tax-exempt status because it had “adopted a stance so doctrinaire” that it could not meet the “full and fair exposition” standard articulated in the definition quoted above. Appellant’s response is threefold. First, it argues, the “full and fair exposition” hurdle is not applicable at all here because BMR, Inc. is not an organization whose primary activity or principal function is advocacy of change. Second, BMR, Inc. contends that its publication does satisfy the requirements of the “full and fair exposition” standard. Finally, appellant maintains that denial of its application for tax-exempt status on the basis of the “full and fair exposition” standard is unconstitutional for a number of reasons.

Even though tax exemptions are a matter of legislative grace, the denial of which is not usually considered to implicate constitutional values, tax law and constitutional law are not completely distinct entities. In fact, the First Amendment

26 U.S.C. §501(c) (1976).

was partly aimed at the so-called “taxes on knowledge,” which were intended to limit the circulation of newspapers and therefore the public’s opportunity to acquire information about governmental affairs. In light of their experience with such taxes, the framers realized, in the words of Mr. Justice Douglas, that “(t)he power to tax the exercise of a privilege is the power to control or suppress its enjoyment.” *Murdock v. Pennsylvania*, 319 U.S. 105, 112, 63 S. Ct. 870, 874, 87 L. Ed. 1292 (1943). Thus, although First Amendment activities need not be subsidized by the state, the discriminatory denial of tax exemptions can impermissibly infringe free speech. Similarly, regulations authorizing tax exemptions may not be so unclear as to afford latitude for subjective application by IRS officials. We find that the definition of “educational,” and in particular its “full and fair exposition” requirement, is so vague as to violate the First Amendment and to defy our attempts to review its application in this case.

[Editor’s Note: The tax exemption for charitable organizations crosses paths with the First Amendment throughout this book. Much of the work that goes on in charitable organizations constitutes protected speech under the First Amendment, which complicates IRS and state regulation of such organizations.]

III. Vagueness Analysis

Vague laws are not tolerated for a number of reasons, and the Supreme Court has fashioned the constitutional standards of specificity with these policies in mind. First, the vagueness doctrine incorporates the idea of notice—informing those subject to the law of its meaning. A law must therefore be struck down if “men of common intelligence must necessarily guess at its meaning.” *Hynes v. Mayor of Oradell*, 425 U.S. 610, 620, 96 S. Ct. 1755, 1760, 48 L.Ed.2d 243 (1976).

Second, the doctrine is concerned with providing officials with explicit guidelines in order to avoid arbitrary and discriminatory enforcement. To that end, laws are invalidated if they are “wholly lacking in ‘terms susceptible of objective measurement.’” *Keyishian v. Board of Regents*, 385 U.S. 589, 604, 87 S. Ct. 675, 684, 17 L.Ed.2d 629 (1967) (quoting *Cramp v. Board of Public Instruction*, 368 U.S. 278, 286, 82 S. Ct. 275, 280, 7 L.Ed.2d 285 (1961)).

These standards are especially stringent, and an even greater degree of specificity is required, where, as here, the exercise of First Amendment rights may be chilled by a law of uncertain meaning. Vague laws touching on First Amendment rights, noted the Supreme Court in *Baggett*,

require (those subject to them) to “steer far wider of the unlawful zone,” than if the boundaries of the forbidden areas were clearly marked, . . . by restricting their conduct to that which is unquestionably safe. Free speech may not be so inhibited.

377 U.S. at 372, 84 S. Ct. at 1323 (quoting *Speiser v. Randall*, 357 U.S. 513, 526, 78 S. Ct. 1332, 1342, 2 L.Ed.2d 1460 (1958)) (citation omitted). Measured by any standard, and especially by the strict standard that must be applied when First Amendment rights are involved, the definition of “educational” contained in Treas. Reg. §1.501(c)(3)-1(d)(3) must fall because of its excessive vagueness.

We do not minimize the difficulty and delicacy of the task delegated to the Treasury by Congress under section 501(c)(3) of the Code. Words such as “religious,” “charitable,” “literary,” and “educational” easily lend themselves to subjective definitions at odds with the constitutional limitations we describe above. Treasury bravely made a pass at defining “educational,” but the more parameters it tried to set, the more problems it encountered.

The first portion of the regulation relied upon to deny BMR, Inc.’s request for tax-exempt status measures an applicant organization by whether it provides “instruction of the public on subjects useful to the individual and beneficial to the community.” Treas. Reg. §1.501(c)(3)-1(d)(3)(i)(b) (1959). The district court rejected that test with barely a murmur of disagreement from appellees. That standard, held the court below, “would be far too subjective in its application to pass constitutional muster.” 494 F. Supp. at 479 n.6.

We find similar problems inherent in the “full and fair exposition” test, on which the district court based affirmance of the IRS’s denial of tax-exempt status to BMR, Inc. That test lacks the requisite clarity, both in explaining which applicant organizations are subject to the standard and in articulating its substantive requirements.

A. Who Is Covered by the “Full and Fair Exposition” Test?

According to the terms of the Treasury regulation, only an organization that “advocates a particular position or viewpoint” must clear the “full and fair exposition” hurdle. Appellant maintains that the definition of an advocacy organization is to be found in the preceding subsection of the regulation, which defines the term “charitable”:

The fact that an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinion on controversial issues with the intention of molding public opinion or creating public sentiment to an acceptance of its views does not preclude such organization from qualifying under section 501(c)(3) so long as it is not an “action” organization of any one of the types described in paragraph (c)(3) of this section.

Treas. Reg. §1.501(c)(3)-1(d)(2) (1959). The district court held that this part of the regulation was designed to cover charitable institutions and that BMR, Inc., an educational rather than a charitable organization, must meet the “full and fair exposition” standard rather than the more lenient “action organization” standard of section 1.501(c)(3)-1(d)(2).²² Obviously, if BMR, Inc. is an advocacy group and is not a charitable organization, it may not take cover under the “action organization” standard but must instead meet the “full and fair exposition” test.

The initial question, however, is whether or not BMR, Inc. is an advocacy group at all. What appellant turns to Treas. Reg. §1.501(c)(3)-1(d)(2) for is the definition of “advocacy,” not for the appropriate standard to be applied to advocacy

²² [FN9] An action organization is one that tries to influence legislation or participates in any political campaign. See 26 U.S.C. § 501(c)(3) (1976). . . .

organizations seeking tax-exempt status. The district court did not deal with that question, and, indeed, it is difficult to ascertain from the language of the regulation defining “educational” exactly what organizations are intended to be covered by the “full and fair exposition” standard and whether or not the definitions of advocacy groups are the same for both educational and charitable organizations.

The uncertainty of the coverage of the “full and fair exposition” standard is evidenced by its application over the years by the IRS. The Treasury Department’s Exempt Organizations Handbook has defined “advocates a particular position” as synonymous with “controversial.”²³ Such a gloss clearly cannot withstand First Amendment scrutiny. It gives IRS officials no objective standard by which to judge which applicant organizations are advocacy groups—the evaluation is made solely on the basis of one’s subjective notion of what is “controversial.” And, in fact, only a very few organizations, whose views are not in the mainstream of political thought, have been deemed advocates and held to the “full and fair exposition” standard. The one tax-exempt homosexual organization cited by the Government as evidence that the IRS does not discriminate on the basis of sexual preference was required to meet the “full and fair exposition” standard even though it admittedly did not “advocate or seek to convince individuals that they should or should not be homosexuals.” Rev. Rul. 78-305, 1978-2 C.B. 172, 173.

The Treasury regulation defining “educational” is, therefore, unconstitutionally vague in that it does not clearly indicate which organizations are advocacy groups and thereby subject to the “full and fair exposition” standard. And the latitude for subjectivity afforded by the regulation has seemingly resulted in selective application of the “full and fair exposition” standard—one of the very evils that the vagueness doctrine is designed to prevent.

B. What Does the “Full and Fair Exposition” Test Require?

The Treasury definition of “educational” may also be challenged on the ground that it fails to articulate with sufficient specificity the requirements of the “full and fair exposition” standard. The language of the regulation gives no aid in interpreting the meaning of the test:

An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.

Treas. Reg. §1.501(c)(3)-1(d)(3) (1959). What makes an exposition “full and fair”? Can it be “fair” without being “full”? Which facts are “pertinent”? How does one tell whether an exposition of the pertinent facts is “sufficient . . . to permit an individual or the public to form an independent opinion or conclusion”? And who

²³ [FN11] “Organizations doing research or educating the public on controversial public issues must stick to the reasoned approach and avoid unsupported opinion.” 3 Int. Rev. Manual-Admin. (CCH) pt. 7751, § 345.(12), at 20,572 (Apr. 28, 1977).