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**NONPROFIT LAW:**  
**TEN ISSUES IN SEARCH OF RESOLUTION**

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# NONPROFIT LAW: TEN ISSUES IN SEARCH OF RESOLUTION<sup>1</sup>

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## Introduction

The laws and regulations governing nonprofit organizations in different countries can usefully be assessed in terms of how they address ten basic issues. To be sure, these are not the only issues relevant to nonprofit law. What is more, countries can address these issues in different ways or choose not to address them at all. But these issues are certainly among the most fundamental in the field, and they provide a useful framework in terms of which the separate national treatments of nonprofit organizations can fruitfully be compared. More specifically, these ten issues are the following:

- (1) *the overall legal context, including protections for the right to associate;*
- (2) *eligibility for nonprofit status;*
- (3) *internal governance requirements;*
- (4) *tax treatment of the income of the organizations and of contributions to them;*
- (5) *personal benefit restrictions;*
- (6) *organizational obligations to the public, such as reporting and other requirements;*
- (7) *permissible business activities;*
- (8) *other financial limitations;*
- (9) *permissible political activity; and*
- (10) *key trends affecting the sector.*

The purpose of this paper is to examine these issues more closely, to identify what they are and why they are important. The focus, in other words, is on the *questions* that must be addressed in laws related to nonprofit organizations rather than on the *answers* different countries provide to these questions. No attempt is made here, therefore, to summarize the rich texture of national treatments will be covered in the subsequent chapters of the book from which this paper is excerpted. Nor is there any attempt to identify an “ideal” legal treatment of organizations.<sup>4</sup> Our purpose here, rather, is

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<sup>1</sup> This paper is scheduled for publication as chapter 2 in Lester M. Salamon, editor, *The International Guide to Nonprofit Law*. (New York: John Wiley and Sons, forthcoming 1997). Reprinted by permission.

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<sup>4</sup> Readers interested in advice on how at least some of these issues might be handled are referred to the *International Statement of Principles for the Voluntary Sector* developed by an international team of experts in this field. A copy of this statement may be obtained by writing to: Voluntary Sector Principles Statement; Institute for Policy Studies, The Johns Hopkins University, 3400 N. Charles St., Baltimore, MD 21218, USA.

the more limited one of making clear what the central issues are that must be resolved in a developing a body of law about nonprofit organizations and what considerations each one entails.<sup>5</sup>

## Issue 1: Legal Context

### Rule of Law

A first basic issue relating to the legal treatment of nonprofit organizations in a country involves not nonprofit law *per se* but the broader legal context within which the legal treatment of nonprofit organizations is rooted. Of central concern here is the extent to which the rule of law is firmly established within a legal system. Also crucial is the extent to which there are guarantees of basic rights of citizens to speak freely, to associate or assemble for nonviolent purposes, to form associations, and to hold private property. These rights are fundamental to creating a legal space within which nonprofit organizations can function, a space that is clearly outside of the state and protected from arbitrary state action.

An important guarantor of such a space is the existence of an independent judiciary able to enforce adherence to law even on the part of the state. Where such a tradition is firmly established, the possibilities for an effectively functioning nonprofit sector are much greater.

### Common Law vs. Civil Law

Such broad legal protections can either be explicitly identified in constitutions and/or laws or embedded in legal traditions built up over centuries through case law. Generally speaking, the former is more likely in countries utilizing civil law systems and the latter in common law countries, where legal traditions have evolved through centuries of judicial interpretation.

Which of these two basic types of legal systems is most congenial to the establishment of a firm right to associate is difficult to determine *a priori*. In truth, both have advantages and disadvantages. The advantage of the common law system is that the right to associate is typically assumed to exist even in the absence of positive law explicitly permitting it. Because of this, common law countries are often considered more hospitable to the existence of nonprofit organizations (Salamon and Anheier, 1994b). At the same time, however, the exact character of these protections may be more ambiguous in such systems. For example, the U.S., traditionally considered a common law country, has long recognized the importance of protecting the right of citizens to

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<sup>5</sup> We use the term “nonprofit organization” as a short-hand to refer to a broad array of entities that meet five crucial requirements: they are organized, they are not part of the state structure, they do not distribute profits to their members; they are self-governing; and they involve some meaningful voluntary input. The exact specification of what constitutes a “nonprofit organization” as the term is used here varies considerably from country to country. What is more, the terminology used to depict the resulting organizations also varies widely. For our purposes here, however, we follow the terminology adopted by the U.N. System of National Accounts, which refers to “nonprofit organizations,” and rely on the definition above merely to establish the general domain in which we are interested, recognizing that the precise specification of this domain is one of the central issues that has to be resolved in this field.

associate freely in order to check undue concentrations of power and protect liberty (Barron and Dienes, 1986:242-262). Yet, this widely recognized right of association is nowhere explicitly mentioned in the U.S. Constitution or its amendments. Rather, it is a byproduct of other rights that are constitutionally rooted. One of the roots is the so-called “freedom of intimate association,” which is derived from the right of personal liberty.<sup>6</sup> A second is the so-called “freedom of expressive association,” which is derived from the right of free speech provided by the First Amendment to the U.S. Constitution.<sup>7</sup> Pursuant to this right of freedom of expressive association, individuals may band together, without government interference, to advance charitable, scientific, educational and other ends short of violent overthrow of the government (Hopkins, 1992:§1.5). In other words, an inherent right to associate is assumed to exist in the U.S. regardless of whether specific legal provisions exist for it, but the exact scope and contours of this right are not spelled out very clearly in any constitution or law, but rather must be found scattered throughout numerous judicial opinions delivered over two centuries.

Traditionally, the situation in civil law countries is just the obverse. In such countries, no inherent right to associate is acknowledged. Rather, such rights exist only to the extent that they are explicitly provided for in basic laws. As such, they can be hedged and conditioned. At the same time, however, once explicitly spelled out they can be more precisely protected and defended.<sup>8</sup>

### One Law or Many

Beyond these broad legal structural issues, there is a basic question of whether the laws regulating nonprofit organizations will be in one all-purpose nonprofit law, or spread throughout different laws, e.g., one law for creating nonprofit entities of various types, another law for beneficial tax status for nonprofits, etc. Basic decisions must also be made about whether to embody the legal provisions relating to nonprofit organizations in a single body of law that relates more or less

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<sup>6</sup> For example, the U.S. Supreme Court has stated:

[I]t is beyond debate that freedom to engage in association for the advancement of beliefs and ideas is an inseparable aspect of the ‘liberty’ assured by the Due Process Clause of the Fourteenth Amendment, which embraces freedom of speech.

See *National Association for the Advancement of Colored People v. Alabama*, 347 U.S. 449 (1958); see also *N.A.A.C.P. v. Button*, 371 U.S. 415 (1963). The “due process clause” of the Fourteenth Amendment states, “...nor shall any State deprive any person of life, liberty, or property, without due process of law....”

<sup>7</sup> The First Amendment to the U. S. Constitution provides:

Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech or of the press, or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances.

<sup>8</sup> In practice, the distinctions between systems of civil law and common law have narrowed considerably in recent years. Even countries traditionally thought of as common law countries, such as the U.S., are no longer clearly so, since today large parts of U.S. law are also contained in codes. Further, in some civil law countries parts of the law have been developed by courts without having been reduced to codes, and some civil law code provisions have been dominated by judicial interpretation. Today the most significant difference between the two systems is characterized largely by modes of procedure and to some extent by the types of personnel by whom justice is administered (see generally David and Brierley, 1990).

generally to the entire class of such organizations or to provide special legal provisions for the many different types of entities that comprise this class. An example of the latter approach is that found in Japan, which, for the most part, separately authorizes the existence of nonprofit-type institutions in each of a variety of different fields (e.g., health, social services, education, research), but provides only limited general rights to form such organizations outside these fields. An example of a more integrated body of law is that afforded by France, where the Law of July 1st, 1901 acknowledged a general right to form associations and mutual benefit organizations for a wide variety of purposes. While either approach can accomplish the same purpose, it is probably the case that comprehensive laws are more likely to provide the firmest and broadest protection for the right to associate and form nonprofit organizations. At the same time, such laws can also more efficiently limit the rights of nonprofit organizations. A set of general provisions supplemented by more specific guarantees to form nonprofit organizations for particular purposes may therefore be desirable in many circumstances.

### National vs. Local Approaches

Closely related to the question of whether nonprofit laws are embodied in one comprehensive law or in particular laws covering particular fields is the question of whether such laws are national in scope or vary by locale. The answer to this question will likely be determined by the general legal and political structure of a country. In the U.S., for example, nonprofit organizations are governed by both state and national laws--the former relating to the basic formation of nonprofit entities and the local taxation of them, and the latter to the national tax treatment of these entities. In France, by contrast, the legal treatment of nonprofit-type organizations is much more fully nationalized.

## **Issue 2: Organizational Eligibility**

Regardless of whether a country is a civil law or common law country, or whether nonprofit organizations are covered by a single comprehensive law or a variety of separate laws, specific provisions must be made to recognize such organizations as legal or juridical “persons.” This is so for the obvious reason that such organizations are typically afforded certain special privileges (and certain corresponding obligations), which makes it necessary or desirable for them to be recognized in law. It consequently becomes necessary to define the features that qualify organizations for such legal recognition. For the sake of convenience, we will refer to this as the issue of “organizational eligibility.”

The issue of organizational eligibility, in turn, involves a number of sub-issues. Four such sub-issues in particular can be distinguished:

- (a) the specification of the *types of entities* that can be recognized as nonprofit organizations;
- (b) the *types of purposes* for which nonprofit status is considered appropriate;
- (c) any *other requirements* that must be met for an organization to be considered a nonprofit organization (e.g., membership requirements or capital asset requirements); and

- (d) the actual *registration procedures* that organizations must follow to be recognized officially as nonprofit organizations.

### **Sub-Issue (a): Eligible Entities.**

To be recognized in law, i.e., to enjoy juridical personality with its accompanying rights and obligations, nonprofit organizations must first of all be “organizations.” That is, they must have some institutional reality to them as reflected in regularized patterns of behavior, internal procedures, and, presumably, governing officers. As the Internal Revenue Service has put it in the U.S., “formless aggregations of individuals” cannot qualify for nonprofit status (U.S. Internal Revenue Service, n.d.: §§ 315.1, 315.2 (3), 315, 4 (2)).

In other words, some act must be undertaken that transforms the group of individuals into a formally constituted, legal or juridical person, distinct from those individuals. However, the exact type of entity and the means of formally creating it can vary widely. For example, in Germany, the types of entities that may constitute nonprofit entities include registered and unregistered associations, private and public law foundations, and private and public law corporations. Generally, however, six basic types of nonprofit entities are most common.

*Nonprofit corporations.* Perhaps the most common formal type of nonprofit organization is the nonprofit corporation. Nonprofit corporations are entities normally granted juridical person status by some governmental body. The great advantage of corporations is that their liabilities can be limited to assets held in the name of the corporation, thereby protecting the assets of those directors or officers who act on behalf of the corporation from claims against the corporation.

*Unincorporated associations.* A second common type of nonprofit organization is the unincorporated association. An unincorporated association is essentially a group of people bound together for common purposes that are not profit-distributing in character. In some jurisdictions, where such a body complies with certain legal formalities, it may obtain juridical person status and will be able to enjoy certain rights of juridical persons, such as the right to sue and hold property.

Typically, it is not necessary to have government approval to create an unincorporated association. In the U.S., for example, the group of persons merely writes a constitution or articles of association stating the name of the association, its purposes, the members of the initial governing body, whether the association will have members, what will happen to assets on dissolution, and certain other basic formalities, much the same as those contained in articles of incorporation for a nonprofit corporation.

For such associations, however, liability may not be limited to the assets of the association, and thus there would be little or no protection afforded to members of the association. Partly because of the unlimited liability feature of associations, some countries have enacted laws granting “quasi-corporate” status to certain types of unincorporated associations. In the U.K., for example, “friendly societies” organized to provide for the relief or maintenance of members or their families

during illness, old age, etc., have been granted some of the legal prerogatives of corporations while still remaining unincorporated entities.

*Mutual societies.* Another possible type of nonprofit entity is the mutual society. A mutual society is a type of association in which members join together to help themselves, e.g., to advance the interests of a profession. In some countries, this class of associations is given special legal status. This is so, for example, in France, where “mutuals” are one of three types of nonprofit entities that are juridical persons, the other types being associations and cooperatives.

*Foundations.* Another type of nonprofit entity is the foundation. Distinguishing features of foundations are that they have endowments of their own, although some jurisdictions do not require an endowment; and that they are managed by directors to serve the public interest.

*Trusts.* Another type of nonprofit entity is a trust, though not all trusts are nonprofit. The trust may be nonprofit where the purpose of the trust is a nonprofit purpose or the class of beneficiaries constitutes a charitable class. Like a foundation, a trust differs from an association in that it is less an aggregation of individuals than an aggregation of resources put into the hands of an individual or corporate trustee(s) to manage in pursuit of some specific purpose defined by the donor. However, unlike a foundation, the trust does not enjoy juridical person status in most jurisdictions, and its trustees remain legally at risk.

*Other.* In addition to corporations, unincorporated associations, mutual societies, foundations, and trusts, nonprofit organizations can also take a variety of other legal forms. Civil law countries often distinguish, for example, between *public law corporations* and *private law corporations*--the former applying to the public sector, and the latter to private, entities. Because nonprofit organizations are typically private in form but public in purpose, they can often be found in both forms in civil law countries. Thus, some private, nonprofit organizations in Germany are registered under public law as public law corporations while others are registered under private law as private law corporations.

In countries where even these general legal provisions for nonprofit organizations do not exist, things can often be even more complex. This is the case in Japan, for example, where separate laws exist for each major type of nonprofit organization--e.g., medical corporations (*iryō hojin*), educational corporations (*zaidan hojin*), or social welfare corporations (*shakai fukushi hojin*).<sup>9</sup>

How many different types of entities to specify as eligible for nonprofit status is difficult to determine in the abstract, of course. The more different types permitted, the easier it is to calibrate the privileges or requirements each can enjoy, but the more complicated it is to keep track of what is permitted or prohibited.

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<sup>9</sup> For information on these various types of Japanese nonprofit corporations, see Salamon and Anheier, 1994a:45-48.



For example, until 1969, U.S. tax law made no distinction between what have come to be known as “foundations”—i.e. nonprofit entities having endowments controlled by a board or the corporation that originally contributed the endowment—and all other nonprofit charitable entities. Because of a variety of perceived abuses among private foundations, however, for tax purposes the U.S. Congress established a separate definition of foundations and subjected them to payout and excise tax requirements as well as additional regulations and reporting requirements in order to ensure that their funds were indeed devoted to public, rather than private, purposes.

While allowing a multitude of types of entities to qualify for nonprofit status can make it easier to calibrate requirements and privileges, however, it can also vastly complicate the job of forming such organizations. Since this sector is preeminently designed to afford citizens an easy mechanism through which to join together to meet common goals, such complexity can easily become self-defeating. This dilemma suggests the need for some middle course between overly detailed and unduly one-dimensional specification of the legal entities eligible for nonprofit status.

### **Sub-Issue (b): Eligible Purposes.**

Closely related to the type of entity that is eligible for nonprofit status is the question of the type of *purpose* that the entity pursues and the disposition of any profit that it generates. More specifically, three types of purposes are commonly associated with nonprofit status. One of these is associated negatively and the other two positively.

In the first place, organizations pursuing primarily *commercial purposes* are typically *not* considered eligible for nonprofit status. The form that this prohibition takes can vary widely. On the one hand, organizations that engage in any commercial activity, including the collection of fees for their own services, can be considered “commercial” and therefore ineligible for nonprofit status. On the other hand, organizations can actively engage in business activities and still qualify as nonprofit organizations so long as the profits thus earned are used wholly to support a broader “public” purpose and are not distributed to the directors, officers, or members. There are thus “maximum” and “minimum” tests of this non-commercial purpose criterion. At a minimum, organizations that earn profits and distribute them to their directors or officers are normally considered outside the nonprofit sector.

Beyond this negative requirement, a more demanding test often stipulated in law concerns the positive purposes that these organizations serve. Two broad types of purposes are common here.

The less demanding of these purposes is *mutual benefit*. Under the mutual benefit test, an organization can qualify for nonprofit status if it works to the benefit of the members of the organization. Such a purpose would embrace professional societies, unions, business interest groups, cooperatives, “friendly societies,” social and sports clubs, and related organizations.

A more demanding test is the criterion of *public benefit*. Under this test, an organization can be considered nonprofit only if it benefits the whole community or an appreciable section of it. What this means in practice, of course, is often difficult to specify. The definition of what constitutes a “public benefit” is therefore often left to the accumulation of case law or the evolving judgment of

legislative bodies. Some guidance on the meaning of this test is available in the common law notion of “charity” as developed in England.

According to English law, a purpose is considered “charitable” if it falls “within the spirit and intendment” of the preamble to the Charitable Uses Act of 1601.<sup>10</sup> This preamble contained a catalogue of charitable purposes that 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, havens, churches, sea-banks and highways, education and preferment of orphans, relief, stock, or maintenance for houses of correction, marriages of poor maids, aid or ease of any poor inhabitants...setting out of soldiers and other taxes....

More generally, this list of charitable purposes, plus others added in subsequent case law, were summarized in a famous court decision in 1891 under four broad headings: *first*, relief of poverty; *second*, advancement of education; *third*, advancement of religion; and *fourth*, “other purposes beneficial to the community,” which includes a broad array of activities such as assistance to the disadvantaged, relief of the sick, preservation of culture or the natural environment, and protection of the welfare of animals.<sup>11</sup> This English concept of “charity” so defined and elaborated has become a touchstone for the definition of “public purposes” in many parts of the world. The U.S. tax law, for example, uses the term “charitable purposes” as one of the defining features of the most important class of U.S. tax-exempt organizations, the so-called 501(c)(3) organizations.<sup>12</sup>

The three broad classes of nonprofit purposes identified here--noncommercial or non-profit-distributing, mutual benefit, and public benefit--potentially identify three broad classes of nonprofit organizations. These broad classes can in turn be accorded different treatment in tax and other laws or be subjected to different types of requirements. In the U.S., for example, organizations that meet either the mutual benefit or public benefit test are eligible for exemption from corporate income tax and from property taxes in most states and localities. However, only those meeting the public benefit test are eligible to receive tax deductible gifts from the public.

Whether, and how fully, a country embodies these three purposes in its own legal structure can vary greatly, of course, depending on local circumstances and traditions. So, too, can the way in which the standard is applied. Thus, an organization can be considered nonprofit if just some or

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<sup>10</sup> 43 Eliz. c. 4 (1601). This was repealed by the Charities Act of 1960, §5.

<sup>11</sup> *Commissioners for the Special Purposes of the Income Tax v. Pemsel*, [1891] A.C. 531 (H.L.).

<sup>12</sup> U.S. Internal Revenue Code (“IRC”) §501(a) provides for exemption from United States income taxation for organizations described in IRC §501(c)(3), which embodies certain restrictions:

(3) [organizations] organized and operated exclusively for religious, charitable, scientific...or educational purposes...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...and which does not participate in, or intervene in...any political campaign on behalf of (or in opposition to) any candidate for public office.

most of its activities are for “public benefit,” or it may be necessary to show that it operates *exclusively* for “public benefit.”

### **Sub-Issue (c): Other Requirements.**

In addition to restricting nonprofit status to entities pursuing particular kinds of purposes, laws can also stipulate other requirements that entities must meet before they are granted nonprofit status. Two of the most common of these are *capital requirements* and *membership requirements*.

*Capital requirements* apply most commonly to trusts or foundations, which can be required to have a minimum level of resources in order to qualify for nonprofit or foundation status. In addition, a foundation may be required to pay out for nonprofit purposes all or a portion of its annual earnings or a stated percentage of its assets, whatever they may be. The rationale for such provisions may be to limit the foundation mechanism to organizations that really have a meaningful level of resources to distribute on behalf of their intended beneficiaries, and to make certain that foundations actually distribute resources for public purposes. Otherwise there is the risk that individuals will abuse the foundation form to gain the tax advantage it sometimes affords while essentially operating a private business.

*Membership requirements* perform a similar function with respect to associations, which can be required to have a minimum number of members in order to qualify for nonprofit status. Here, again, the intent is to reduce the chances that associations will function as mere “shells” or fronts for business organizations, benefiting from the tax and other legal privileges accorded to nonprofit organizations without actually serving a constituency or membership of interested people.

Beyond these capital and membership requirements, nonprofit organizations can also be subjected to other requirements as a condition of recognition of nonprofit or beneficial tax status, or even of juridical personality. In Japan, for example, the responsible ministry in each field must explicitly give its approval for the formation of each nonprofit organization, certifying that the organization will meet a need that the ministry feels a nonprofit organization can appropriately address (Amenomori 1993).

### **Sub-Issue (d): Registration Procedures.**

Whatever the permissible legal forms, purposes, or other requirements that nonprofit organizations must possess, there remains the separate issue of how an organization’s compliance with these requirements is verified.

*Juridical Person vs. Beneficial Tax Status.* The first thing to note about such compliance procedures is that they can apply at either or both of two separate stages in the process of identifying a nonprofit entity: first, at the point where juridical person status is established; and second, at the point where recognition of beneficial tax status of various kinds is established. As discussed above, juridical person status of a nonprofit entity in some instances requires no government approval, and in such cases, it is only with respect to beneficial tax status that government approval may be required. In other instances, however, recognition of juridical personality and beneficial tax status

are both required. As will be discussed below, in either instance, certain documents may have to be prepared in prescribed form, or forms completed, or fees paid.

*Exception Basis vs. Registration Basis.* Regardless of whether eligibility requirements are imposed at the stage at which an entity acquires juridical person status, or at the stage at which it secures beneficial tax status, two broad approaches are available for ensuring compliance with these requirements. The first might be termed the “exception basis.” Under this system, organizations that fit the requirements of the law are assumed to be valid nonprofit organizations unless government takes exception through established legal procedures. Such exceptions can be entered by tax authorities or specially constituted legal entities such as a Charity Commission or Attorney General empowered to protect the public against falsely operating nonprofit organizations. The alternative is the “registration basis.” Here all organizations seeking to operate as nonprofit organizations must register with a governmental authority and satisfy this authority that they comply with the requirements for nonprofit status.

Generally speaking, the “exception basis” has historically been most widespread in common law countries, where the right to form nonprofit organizations is presumed to predate any legislative enactment establishing such a right or governing its exercise. Organizations therefore may be free to operate as nonprofit organizations without explicitly registering with any governmental authority, in some instances even including beneficial tax status and other privileges. In civil law countries, by contrast, no such inherent right is assumed, making it far more essential for organizations to secure explicit recognition as nonprofit entities in order to function in this capacity.

Although common law countries have historically relied much more heavily on the “exception basis,” in practice the “registration basis” has come to be increasingly important in such countries as well. One reason for this development is that the tax and other benefits available to nonprofit organizations have grown increasingly sizable, making it increasingly important for organizations to be certain of their eligibility for such benefits. Registration is one way to verify that eligibility. Thus, in the U.S., nonprofit organizations having more than \$5,000 in aggregate revenues each year that wish to attract tax deductible contributions and private foundation grants find it desirable to seek recognition from the Internal Revenue Service within 27 months of formation. If recognition of tax exemption is not applied for within 27 months of creation, the organization may be subject to regular corporate or trust tax liability for the period from formation until the IRS recognizes its exemption, and donors cannot deduct contributions during this period. While not required to seek such status, increasing numbers of organizations therefore choose to do so. A similar situation exists in the U.K., where associations seeking to benefit from tax privileges on donations find it in their interest to register as charities with the Charity Commission. Thus, the shape and character of registration procedures has become increasingly important even in common law countries.

*Degree of Discretion.* A variety of considerations must be taken into account in the design of such procedures. Perhaps the most important of these is the degree of discretion to vest in the authorities operating the registration process. At one extreme are systems that allow nonprofit organizations to self-define their purposes and vest in registering authorities only the discretion to

verify that the claimed purposes are consistent with those stipulated in law or legal tradition and that the organization complies with minimum requirements as to legal form (e.g., that it has bylaws, an address, and designated officers). At the opposite extreme are systems that vest in registering authorities the power to determine whether a particular organization is needed in a particular field, regardless of whether its purposes are consistent with those stipulated in law.

*Locus of Registration Authority.* Closely related to the degree of discretion left to registration authorities is the locus of this authority. Several options are available here as well. Thus, registration authority can be vested in courts or in executive agencies. What is more, these can operate at the national or local level. If registration authority is vested in executive agencies, it can be vested either in authorities that specialize in overseeing nonprofit organizations, such as the Charity Commission in the U.K., or in authorities that have other functions as well. So far as other authorities are concerned, these can either be tax authorities or specialized ministries with responsibility over particular functions (e.g., health, education, research).

The advantages and disadvantages of these various routes are difficult to specify in the abstract. As a general rule, however, court-based systems may be the most open, but they raise potential problems with regard to appeals since adverse judgments would normally be appealed to the courts. Among administrative systems, those that vest registration power in tax authorities seem likely to be most restrictive since tax authorities are likely to view nonprofit organizations as drains on the tax revenues that such authorities are responsible for raising. Similarly, functional ministries may be too jealous of their prerogatives to support the widespread emergence of nonprofit organizations in their spheres. That, at any rate, has been the experience in Japan where such authorities hold a powerful strangle-hold on the registration of nonprofit organizations, frequently driving persons motivated by nonprofit purposes to operate completely outside the law, without benefit of registration, government funding or beneficial tax status, and therefore unregulated and subject to abuse. A separate nonprofit registration authority may therefore be most promising and easiest for nonprofits to use.

*Burdensomeness.* Another crucial dimension of the registration procedures for nonprofits concerns the degree of burdensomeness of the process. Included here is the extent of information required of the applying organization, the nature of the verification that must be provided, and the length of time involved. This is affected as well by the basic structure of the process. In practice, registration can entail one integrated process, or it can often entail several different steps, each involving a different authority. In the U.S., for example, organizations must generally register at the state level to create a legal entity such as a nonprofit corporation, then go to the federal level for recognition of beneficial tax status, then return to the state level to a different agency for state and local beneficial tax status, and finally apply to yet a different state agency to register for charitable solicitation purposes. While none of these steps in and of itself is unduly burdensome, the combination can create a significant obstacle to the formation of voluntary grass-roots organizations.

*Duration.* Closely related to the question of how long it takes to become registered for juridical person status, beneficial tax status, or both, is the question of how long an organization remains registered. At issue here is whether registration should be granted permanently or for a

limited period, with the right to renew. The virtue of the latter is that it provides a regular check on the compliance of organizations with their originally stated mission. The drawback is that it can give governmental authorities the opportunity to exercise inappropriate political control over organizations.

Quite apart from the question of whether government might terminate the eligibility of an organization as a nonprofit entity for legal person status or beneficial tax status is the question of the procedures for voluntary dissolution of an organization. What is important here is the specification of who has the right to terminate an organization's existence or beneficial tax status, and what legal act is required and what becomes of any organizational property. We return to these topics below when we discuss organizational governance.

*Appeal Procedures.* Finally, whatever the registration procedures in effect, attention must also be given to the question of how to handle appeals from adverse judgments by the registration authorities. This can be handled administratively, of course, but ultimate appeal to the courts is also an important option.

### **Issue 3: Internal Governance**

The issue of organizational registration and eligibility for juridical person status is, in turn, closely related to a third crucial issue, that of *internal governance*. To be sure, a strong case can be made that matters of internal governance should be left wholly to nonprofit organizations themselves, with no interference from the state. After all, one of the defining features of these organizations is their "self-governing" character, their ability to control their own internal operations. However, there are nevertheless compelling reasons for establishing at least certain broad parameters of internal governance in law.

The first of these derives simply from the status nonprofit organizations acquire as legally constituted entities, as "legal persons" in the meaning of the law. In granting such status to any organization, the state has a right to insist that the resulting "person" make clear who can rightfully act in its name. As a consequence, laws typically contain provisions requiring specification of certain features of governance structure as a condition of creating any legal entity.

Such provisions are even more important for nonprofit organizations for a second reason--their public character and the tax and other privileges they often enjoy as a consequence. As the private Commission on Private Philanthropy and Public Needs in the U.S. put it in the early 1970s, the special status of nonprofits under law, particularly their beneficial tax status and use of government funds, entails "an obligation to openness and accountability to the public for actions and expenditures." (Commission on Private Philanthropy and Public Needs, 1975:21 - 26) This, in turn, requires internal governance arrangements that are at least clear and open.

Finally, the "voluntary" character of these organizations also has implications for the internal governance structure. To preserve their voluntary character, nonprofit organizations must have

internal governance procedures that provide meaningful opportunities for participation by members in the organization's operations.

In framing laws on the internal governance of nonprofit organizations, therefore, policy makers must balance two competing values: first, the value of autonomy and non-interference by the state in the internal affairs of the organization; and second, the need for these organizations to have understandable decision-making structures and to be publicly accountable.

### Laws vs. Governing Documents

One way to achieve this balance is to limit the statutory provisions governing the internal structure of nonprofit organizations to broad general requirements (e.g., the need to specify the locus of ultimate authority in the organization, to identify the role of directors and officers, and to establish operating procedures); and then leave it to the organization to explain in a set of internal governing documents, or "bylaws," how it proposes to meet these broad requirements. The bylaws can then be judged in terms of their compliance with the broad requirements of the law while leaving considerable flexibility for organizations to shape their internal management in a way that makes sense in terms of their purpose and style. Thus, for example, laws may enumerate a range of possibilities for types of governing bodies of organizations or the locus of decision making authority. The bylaws can then specify which is chosen in a particular case.

Whether stipulated in laws or left to governing documents, certain key issues must typically be settled at the time an organization is legally constituted. Four of these issues are particularly important:

- (a) the locus of ultimate authority in the organization;
- (b) the size, terms of office, and role of the governing board;
- (c) the officers of the organization; and
- (d) the decision making procedures the organization will use.

#### (a) The Locus of Authority: Membership vs. Board-Managed Organizations

Perhaps the most basic legal issue concerning the internal management of nonprofit organizations concerns the ultimate locus of decision making power. As noted above, laws will typically require that such authority be clearly and unequivocally fixed. Two broad options are available in the case of nonprofit organizations depending on whether the organization is membership-based or not.

*Membership Organizations.* In the case of *membership organizations*, ultimate authority rests with the "membership" of the organization. How the membership exercises this authority can vary significantly. For organizations with large numbers of members, for example, representative assemblies of members may exercise authority. In such cases, bylaws would have to spell out how the representatives are to be selected, what the attendance must be in order to constitute a "quorum" able to act on behalf of the organization, and whether a simple majority or some type of super

majority is required to act on particular types of resolutions (e.g., a requirement for a three-fifths majority to change the organization's bylaws). Alternatively, meetings of the entire membership may be required in order for the organization to take action. In such cases as well, bylaws must specify what proportion of the membership must be in attendance to make the meeting official and what the voting procedures are.

Because of the cumbersomeness of convening members, even membership organizations often specify a smaller body that is empowered to act on behalf of the members between membership meetings. Such governing boards, or boards of directors, can either be elected or appointed, but they exercise their authority at the pleasure of the membership, and the members often retain for themselves the power over the most important decisions affecting the organization, such as the election of directors and officers and the approval or amendment of the basic organizing documents, or budgets.

*Board-Managed Organizations.* Not all nonprofit organizations have members, however. In such cases, the ultimate authority in the organization lies with the board of directors, by whatever name known. In such *board-managed organizations*, the board has a similar function to that in membership organizations, i.e., to oversee the management of the organization. However, in this case, the board of directors is self-perpetuating and is not subject to the control of a membership. This is typically the case, for example, with foundations, but it is common among service organizations as well.

Due to the more limited outside scrutiny and accountability involved with board-managed organizations, stricter statutory rules may be required to ensure their openness and accountability.

(b) Board Structure.

In the case of both membership or board-governed organizations, laws often address issues concerning the size and terms of office of governing boards of nonprofit organizations. In the first place, laws often require a minimum number of persons who must serve on such boards. This is done to ensure a degree of openness and accountability in the organization. Within limits, the higher the minimum, the greater the number of persons involved in decision making, and presumably, the more open and accountable the organization.

Laws also often require that the bylaws of the organization specify how many board members there will be beyond this minimum. This is done to ensure that it is clear who is authorized to vote on matters affecting the governance of the organization.

Finally, laws frequently require that the organization's bylaws address the length of service of board members, whether successive terms may be served, and if so, what the term limits are.<sup>13</sup> These

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<sup>13</sup> In the U.S., many of the 50 states have adopted nonprofit corporation statutes dealing with many aspects of internal governance just discussed. Many of these states have based their nonprofit corporation statutes on the Model Nonprofit Corporation Act, which was developed by volunteers working on the Committee of Nonprofit Corporations of the Section of Corporation, Banking and Business Law of the American Bar Association (see



provisions, too, are intended to ensure a degree of responsiveness in the organization and provide for orderly procedures for succession.

(c) Officers.

A third issue of internal governance frequently addressed by laws has to do with the officers of the organization. Here, again, laws may stipulate the officers that are required and the powers of each, or leave this to be spelled out in the organization's bylaws. The central point, however, is to clarify who has the right to act for the organization, to enter into contracts on its behalf, to commit funds, and to convene meetings.

An officer is a person who is appointed or elected to take an active part in the administration or management of the nonprofit organization. Bylaws must typically specify the requirements or qualifications for office (e.g., whether officers must be members of the organization and, if so, for how long), the manner of election of officers, whether one person may hold one or more offices, the rights and duties of officers, the authority they have to deal in financial matters and contracts, to keep records, to convene meetings, and the like.

The number and roles of officers can obviously vary widely. Typically, however, there is at least a chief administrative officer, such as a president or chairperson; a chief financial officer, or treasurer, who supervises the financial affairs of the organization; and a secretary, who handles all non-financial records of the organization and maintains records and minutes of all meetings.

(d) Decision Making Procedures.

In addition to stipulating that the authority structure of the organization be clarified, laws can also address the *decision making procedures* the organization will use, or at least require that the organization establish such procedures. Among the procedural issues that typically may be addressed are these:

- the minimum frequency of meetings of the governing body;
- notice requirements for meetings;
- quorum requirements (i.e., the number of members or board members who must be present in order for the organization to conduct its activities officially);
- voting procedures (e.g., whether voting must be in person or can be by proxy or written consent, or by use of telecommunications equipment);
- whether voting is by simple majority for all issues, or whether "super majorities" are required on certain issues (such as changing the bylaws); and
- the operating rules that will be used for the conduct of meetings.

The choice among these various governance options may be left to nonprofit organizations themselves to resolve in their rules for internal governance, by whatever name these documents may

be known. Where laws leave various procedural aspects for the organization to decide, governing bodies may want to specify informal schemes for democratic conduct of meetings such as those embodied in *Roberts' Rules of Order* (1876).<sup>14</sup>

### Summary

In short, although nonprofit organizations are “self-governing,” crucial aspects of their internal governance are nevertheless appropriately the subject of public concern, and therefore an appropriate focus of law. A considerable range of options exists, however, for how rigidly such matters should be prescribed in law, as opposed to simply stipulating in law that organizations must address them in their own governing documents.

### **Issue 4: Tax Treatment**

One of the great advantages that frequently attaches to the nonprofit form of organization is the availability of beneficial tax treatment to some or all such organizations. To be sure, the extent of the tax advantages available to such organizations, and hence the importance of these advantages, varies widely around the world. The U.S. is an extreme case where nonprofit organizations are frequently, though incorrectly, understood to be a product of the federal tax law, and nonprofit organizations are primarily thought of as “tax-exempt entities.” Elsewhere, the tax benefits available to nonprofit organizations may be more limited. Almost everywhere, however, the question of whether to extend beneficial tax treatment to nonprofit organizations and, if so, how and to what extent, is a major issue of law and policy.

#### Rationale for Beneficial Tax Treatment.

Many rationales have been offered to support beneficial tax status for nonprofit organizations.<sup>15</sup> One rationale is that nonprofit organizations are entitled to beneficial tax status because they perform functions that are supportive of central values that a government wishes to encourage, or at least avoid discouraging. For example, it is often said that nonprofit organizations foster democracy, voluntarism and pluralism and that these are values that should be promoted through a supportive tax policy.

A second line of argument justifies special tax advantages for nonprofit organizations on grounds that such organizations relieve government of burdens it would otherwise have to bear. According to this line of argument, nonprofit organizations provide “collective goods” that meet societal needs in such fields as health, education, care for the disadvantaged, or even recreation and culture, that are not likely to be met by for-profit businesses. To the extent a society wishes to have

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<sup>14</sup> These rules are derived from the customs and rules of the English Parliament, which were in turn devised in part from the Roman Senate. These rules are in essence a common law of deliberative assemblies and organizations far less formal. An example would be procedures for making a motion, seconding a motion, calling for a vote, etc.

<sup>15</sup> For an interesting review of tax theory as it relates to nonprofit organizations, see, e.g., Atkinson, 1991, 1990; Chisolm, 1987-1988; Hansmann, 1980.

such needs met, it must either do so directly through governmental action or rely on private voluntary action and contributions to do so instead. Tax subsidies to such private organizations can thus be seen as a way to encourage activity that helps relieve government of responsibilities and costs it would otherwise have to bear directly. The argument for tax subsidies for such activity is strengthened by evidence that the increase in private contributions that is stimulated by such special tax advantages is greater than the loss of revenue to government, so that the subsidies are “cost-effective” in stimulating the desired behavior.<sup>16</sup>

Other theories treat beneficial tax status for nonprofit organizations as a mere technical problem. Since “nonprofit organizations” do not exist primarily to earn a profit and therefore do not compute their net cost of operation, it is sometimes difficult to define what the tax base really is for such organizations, especially for income taxation. What is more, at least some portion of the income and resources of such organizations is often contributed rather than earned, complicating taxation further.

Such arguments are not without detractors, of course. Some object to the use of tax policy to achieve policy goals and argue for equal taxation of all types of entities, whether nonprofit or otherwise. Others point to the opportunities for abuse when one class of entities is exempted from tax obligations levied on other types of organizations, creating powerful incentives for taxed organizations to redefine themselves in ways that make them seem eligible for beneficial tax status. Even where the rationale for beneficial tax status is granted, moreover, important issues still remain concerning the structuring of this treatment.

In practice, the issue of the tax treatment of nonprofit organizations really involves two distinct sub-issues: (a) *the tax treatment of the nonprofit organization itself*, and (b) *the tax treatment of contributions* to these organizations by individuals, corporations, and others.

#### **(a) Tax Treatment of Organizations**

With regard to the tax treatment of nonprofit organizations, several distinct questions must be addressed.

*Type of Organization.* In the first place, if favorable tax treatment is to be accorded to nonprofit organizations, decisions have to be made about whether to provide such treatment to all types of such organizations or only certain types. As noted earlier in this chapter, there are many distinct types of such organizations--foundations, associations, trusts, corporations, etc. In addition, such organizations serve a variety of purposes, such as public benefit and mutual benefit. Given this

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<sup>16</sup> For a review of this evidence, see Clotfelter and Salamon, 1982.

diversity, beneficial tax treatment can either be made available to all types of nonprofit organizations or reserved, in whole or in part, just for some types.

Assuming that some differentiation of tax treatment is considered appropriate, this can be done either in terms of the type of organization or in terms of the type of purpose it serves, though in practice these may overlap. Thus, in some statutory schemes, only certain types of entities are eligible for favorable tax treatment. In other laws, the purpose of the organization, rather than the legal form, is the principal basis for determining tax status. For example, certain kinds of beneficial tax status can be reserved for organizations serving public, as opposed to mutual, purposes, or fulfilling functions considered to be especially critical for national health and welfare. In the U.K., for example, many special tax and other advantages are only available to persons or organizations which serve exclusively charitable purposes.

*Types of Taxes.* Not only can different types of nonprofit organizations be treated differently for tax purposes, but also these differences can vary by the many types of tax, e.g., *income taxes* and *consumption taxes*.

*Income taxes* include taxes on various sources of organizational income. Such income can come from contributions, from earnings on property or investments, from the sale of such assets, from fees for services, and from related and unrelated business activities. Nonprofit organizations can be exempted from taxes on all income or only on certain classes of income. Thus, some income tax laws may allow beneficial tax status for some sources of income--such as gift income, income from carrying out nonprofit purposes, or interest, dividends or other types of passive income from investment sources, while denying it for others. In the U.S., for example, even public-benefit organizations that are generally exempted from income taxation are nevertheless liable for taxes on income from business activities that are "unrelated" to the tax-exempt purposes of the organization.

*Consumption taxes* are taxes on various types of purchases that nonprofit organizations may make. Included here are sales taxes, value-added taxes, luxury taxes, property taxes, and import taxes or duties. Because nonprofit organizations purchase goods and services like other entities, they are sometimes exposed to these consumption taxes even though they may be exempted from the more formal requirements of income taxation. Since consumption taxes can be at least as burdensome for nonprofits as income taxes, it is necessary to pay close attention to these taxes as well.

Not only are there different types of taxes, but these types of taxes may be under the jurisdiction of different governmental entities. For example, in the U.S. and U.K., it is not uncommon for income taxes to fall under the jurisdiction of the national government and property taxes under the jurisdiction of local governments. Tax treatment can therefore vary not only among types of taxes and types of organizations, but also among levels of government.

*Application for Beneficial Tax Status.* In addition to the basic structure and coverage of beneficial tax treatment, consideration must also be given to the process of applying for it. This can

be done either as part of the basic registration procedure for “nonprofit” status described earlier in this chapter, or it can be done as a separate process.

Where beneficial tax status is treated separately from other types of registration, such as for creation of a nonprofit entity, there may be one or more governmental entities that administer beneficial tax status matters. For example, exemptions from income taxation may be extended by the national income tax authorities and exemption from import duties by the foreign ministry. To avoid conflicts, however, countries often establish procedures under which different taxing authorities defer to the judgments made by one central authority in granting other forms of tax benefits. For example, import tax exemptions may be extended automatically to all entities that have been granted income tax exemption.

Whether registration and the granting of beneficial tax status are handled together or separately, there are inevitably varying degrees of discretion vested in the authorities operating such processes. To monitor such exercise of authority and provide some recourse in case of controversy, it is therefore often necessary to establish some appeal process, either to an administrative body or a court of law.

In addition to processes for initial certification of eligibility for beneficial tax status, procedures must also be established for monitoring the continued appropriateness of such status for particular organizations. This can take the form of regular financial and activity reporting requirements. Frequency and detail of reporting are also factors to consider in statutory drafting, as voluminous or frequent reporting may be overly burdensome and costly to nonprofits and government, while insufficient reporting does not give government adequate information to enforce the law or to maintain widespread public confidence in the nonprofit sector.

Consideration is often given to exclusion of small organizations from either applying for beneficial tax status or reporting on such financial matters since the burdens imposed may exceed any likely gain to the government. In countries where there is a strong separation of church and state, consideration must also be given to the degree to which government should require religious entities to report to the state. In the U.S., for example, nonprofit organizations are generally required to file an annual information report to the national income tax authority, but organizations having less than \$25,000 in annual revenue are exempted from the reporting requirement, as are churches, mosques, synagogues and other religious organizations. With respect to the monitoring of these returns, in the U.S. in any given year, it is rare for the federal tax authority to audit more than 1 to 3 percent of nonprofit organizations. It is generally agreed in the U.S. that this is a sufficient level of auditing to prevent serious abuse.

#### **(b) Tax Treatment of Contributions.**

Quite apart from the question of whether nonprofit organizations themselves should pay taxes on all or a portion of their income or purchases is the question of how to treat the contributions made by the donors to such organizations so far as the *donor's tax liabilities*, rather than the organization's tax liabilities, are concerned. By permitting donors to deduct such contributions from their income,

or otherwise extending beneficial tax status to them, governments can provide important incentives for donors to make contributions to nonprofit organizations. In a sense, such special tax advantages reduce the “cost” or “price” of the gift by reducing the tax liabilities that the donor would otherwise bear. Whether such tax incentives actually induce taxpayers to make charitable contributions or merely influence the timing and amount of such gifts is open to debate, but there appears to be compelling evidence that they have some effect at least on the timing and amount of gifts.<sup>17</sup>

As noted earlier, the rationale for such beneficial tax status for giving hinges on the notion that the gifts support essentially public purposes and thereby relieve government of burdens it would otherwise face. Donors contributing to such public purposes are therefore considered to be entitled not to be taxed on the income they devote to these purposes. Critics charge, by contrast, that such incentives are undemocratic since they vest in the hands of private persons decisions over how to allocate revenues that would otherwise come to the government in the form of taxes. Thus, for example, Prime Minister Vaclav Klaus of the Czech Republic denounced tax deductions for voluntary contributions in the early 1990s on grounds that such deductions are undemocratic and place the interests of the donor ahead of the general interests of the public, thereby substituting private preferences for public preferences (Salamon, 1994a).

Once a country has determined that beneficial tax status for contributions is appropriate, several additional questions must still be addressed. Three of these are particularly important: *first*, the types of organizations or purposes for which beneficial tax status for contributions is justified; *second*, the form such favorable treatment should take; and *third*, the types of entities or contributors that should be eligible for such favorable treatment. Let us consider each of these in turn.

*Eligible Organizations or Purposes.* A first question related to the beneficial tax status of contributions concerns the types of organizations or purposes to make eligible for tax privileged gifts. This is similar to the question raised above in connection with the tax treatment of organizations, though the arguments for the one are not necessarily identical to the arguments for the other. For example, it can be argued that both public benefit and mutual benefit organizations serve a public purpose and therefore should be granted beneficial tax status. However, contributors to a mutual benefit organization typically receive some direct benefit in return for their contribution (e.g., participation in social events or assistance with home loans) whereas the benefits of public benefit organizations are distributed more broadly. There may therefore be a stronger argument for extending tax incentives for contributions to public benefit organizations than to mutual benefit organizations. This is the practice under U.S. tax law, for example, where all types of nonprofit organizations are exempted from federal income taxation, but contribution deductions generally are available only for contributions to public benefit organizations (so-called 501(c)(3) charitable organizations). Similarly, U.K. law restricts favorable tax treatment to contributions to persons or organizations whose purposes are exclusively charitable. In France, the limitations are far more

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<sup>17</sup> For a summary of this evidence, see Clotfelter, 1985. While taxation can influence the size of gifts, however, the basic impulse for giving may come from other sources. In the case of U.S. corporate giving, for example, historically the motivators have been characterized as moral imperatives, corporate good citizenship, and enlightened self interest (see Logan, 1989).

severe, and deductibility of contributions is permitted only for a narrow set of organizations judged to be “public utility corporations” by the Council of State.

Tax treatment of contributions can also vary depending on whether the recipient organization and/or its activity is domestic or foreign. Thus, in the U.S., for example, the federal income tax law subjects corporate charitable contributions to a “domestic organization restriction” (“DOR”) (IRC §170(c)(2)(A)). Contributions generally are not deductible unless the donee was created or organized in or under the laws of the U.S., its possessions, any state or territory or the District of Columbia.<sup>18</sup> The law also subjects corporate gifts to a “domestic use restriction” (“DUR”). Generally, in order for a corporate contribution to an unincorporated entity, e.g., a trust, community chest, or other such fund, to be deductible, the contribution must be restricted to use within the U.S. or its possessions.<sup>19</sup>

The policy rationale behind the DOR and DUR rules derives from the “substitution” argument discussed earlier. As the Congress put it:

The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare. *The United States derives no such benefit from gifts to foreign institutions, and the proposed limitation is consistent with the above theory.*<sup>20</sup>

More recently, the DOR and DUR rules have been justified on grounds that U.S. authorities have “virtually no way to make a foreign voluntary organization accountable and assure that moneys going abroad would be used for the philanthropic purpose.” (Rudney, 1978:17) Whether these rationales still hold in the global economy of the present is open to question.

*Types of Tax Treatment.* Whatever the type of nonprofit or activity judged to be worthy of beneficial tax status for contributions, important choices must still be made about such issues as the structure of the tax advantage, the types of gifts that are eligible for such advantages, and the extent or level to which such advantages should be permitted.

With respect to the *structure of the tax advantage*, a number of options are available depending on the nature of the tax system that exists. Two common types are *tax deductions* and *tax credits*. In an income tax context, tax deductions permit taxpayers to deduct all or a portion of their contributions from their income before computing their income tax liabilities. The value of the

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<sup>18</sup> Only the Canadian, Honduran and Mexican tax treaties alter this result in limited circumstances (see Weithorn, 1975:§63.03 [2]).

<sup>19</sup> IRC §170(c)(2). A corporate contribution to a charity organized in the U.S. as a corporation (rather than as an unincorporated trust, association, etc.) is not subject to DUR, however. Thus, often DUR can be avoided by giving to a charity organized in the U.S. in corporate form (see Weithorn, 1975).

<sup>20</sup> U. S. House of Representatives, H. Rept. 1860, 75th Cong., 3d Sess. (1938). [Italics supplied.]

income tax savings of the deduction is then computed as the value of the gift times the tax rate that applies for a given taxpayer. Tax credits, by contrast, permit taxpayers to deduct all or a portion of the value of their contributions, not from their income, but from their actual tax liabilities. Tax credits are generally therefore worth more to the taxpayer than are tax deductions.

Yet another form of tax advantage delivers the benefit of favorable tax treatment not to the donor, but to the recipient organization. Under the “covenant” system in the U.K., for example, taxpayers making charitable contributions pay their regular taxes, and the Treasury then sends the tax that would normally be paid on the contribution to the designated charity.

Different treatment is also sometimes accorded different types of gifts--e.g., whether a gift is in cash or in kind, whether a full interest or just a partial interest in property is donated, the length of time the property may have been held by the donor, or whether the donor receives something in return. In the case of donations of property (e.g., works of art, real estate, or stocks and bonds) important issues arise about how to value the property for purposes of calculating tax benefits. Questions of substantiation and record keeping of contributions must also be considered, both in terms of records to be kept by the contributor as well as records to be kept by the recipient nonprofit organization.

Even where tax laws provide for beneficial treatment of contributions, such treatment can be subjected to certain limits. An eleven country survey recently highlighted the following wide-ranging deduction limits: Austria--10% of taxable profits for firms, for scientific research only; Belgium--5% of income; Hungary--no limits; Israel--35% of gifts that are less than 25% of taxable income; Italy--generally .8% to 2%; Spain--20% of gifts that are less than 30% of taxable income, firms 10%; Taiwan--20% of income for individuals, 10% of profits for firms; and U.K., no limits on gifts of capital, as opposed to current income (Weisbrod, 1991:3). In Japan, there are no percentage limitations on corporate contributions to the government and certain designated entities, while other corporate donations are generally deductible only up to the limit of one half of the sum of 2.5% of current net profits plus 0.25% of paid-in capital and capital surplus, with certain limited exceptions (Flaherty, 1991:58).

### Classes of Donors.

A final issue in the design of beneficial tax status for contributions concerns the types of donors eligible to receive such favorable treatment. Such donors can be individual citizens or businesses of various types (e.g. corporations, partnerships, cooperatives etc.). As suggested above, tax laws can allow beneficial treatment of contributions for all of these but vary the extent of such treatment. In the U.S. for example, the federal tax law makes a distinction between individuals and corporations, generally allowing deductions for contributions of roughly 10% of income for corporations and 50% for individuals.

Ideally, the twin objectives of simplicity and fairness considered in constructing any tax regime should be kept in mind by legislative drafters as they ponder these questions. However, different countries resolve these questions in a myriad of ways, few of which are simple.



### Issue 5: Personal Benefit Restrictions

One of the essential characteristics of nonprofit organizations, is that they are “non-profit-distributing,” i.e., they do not return profits to persons who control the organization. Rather, any such profits must be used to advance the purposes for which the organization was created. This is a key distinction between nonprofit and for-profit organizations and has been variously characterized as the “nondistribution constraint” (Hansman, 1980:838), the prohibition on private benefit, the prohibition on private inurement, or the personal benefit restriction. For purposes of this discussion, we will use this latter term, “personal benefit restrictions,” to refer to a broad set of limitations on the diversion of nonprofit income or assets for private purposes.

The law concerns itself with this issue of personal benefit in order to ensure that nonprofit assets serve a public, rather than a private, purpose, and that beneficial tax status and other favored status are indeed warranted. Further, such laws place restrictions on the use of nonprofit assets in order to maintain public confidence in and support for the nonprofit sector.

Obviously, many persons benefit incidentally from nonprofit assets and earnings. For example, a nonprofit organization may provide social services to a large class of low-income individuals. The provision of these social services to a charitable class is the reason the nonprofit was formed and granted beneficial tax status and is perceived to result in a public benefit, even though particular low-income individuals benefit from receipt of low- or no-cost services. Laws regulating private benefit do not typically attempt to capture this type of incidental or *de minimis* occurrences of private benefit.

Nor do such laws commonly prohibit payment of salaries to employees of nonprofit organizations or of expenses of board members for attendance at regular meetings or other organizational functions. Some laws even permit the payment of fees to board members, though this practice is less common.

What is commonly prohibited are conflict of interest situations in which directors or officers use their position of trust to further their own private interests to the detriment of a nonprofit organization they manage. Some of the types of transactions from which such prohibited personal benefit may result include the following:

- a loan of money or other valuables by a nonprofit to a private individual;
- assumption by the nonprofit of liabilities of an individual;
- payment to an individual or a business of amounts in excess of what would be normal, reasonable compensation for goods or services provided to the nonprofit organization;
- granting a private person permission to use or purchase a nonprofit's facilities or office supplies and equipment at no cost, or low-cost; and
- use of the nonprofit form to operate a for-profit business or to serve business purposes (e.g., allowing a foundation to invest in a business controlled by a board member).

Such transactions amount to an intentional, wrongful diversion to a private individual of nonprofit assets or income, a diversion from public to private purposes, often solely by virtue of that individual's relation to the nonprofit.

Among the critical questions that must be settled in law are the types and extent of such personal benefit restrictions. Typically, such restrictions apply particularly to individuals in positions of control in the organization. These include members of boards of directors and key officers and managers of the organization. In some countries, restrictions of this type may be greater for some classes of nonprofits than for others.<sup>21</sup> These matters may also be dealt with in general criminal laws covering theft, embezzlement, and the like, instead of, or in addition to, a separate law for nonprofits or a tax law.

### **Issue 6: Obligations to the Public**

Closely related to restrictions on utilizing nonprofit resources for private benefit are a set of broader responsibilities to the public at large that laws often place on nonprofit organizations and those who oversee them. Two broad sets of such responsibilities can be distinguished: first, *fiduciary responsibilities*, which refers to the responsibility for handling money or property not one's own for the benefit of another, in this case a nonprofit organization; and second, obligations for *openness and transparency* in the management of the organization. Such provisions are designed to further enhance accountability and transparency, and consequently public confidence in nonprofit organizations, and to ensure that assets that receive beneficial tax treatment remain dedicated to public benefit. Let us examine each set in turn.

#### Fiduciary Responsibilities

Laws relating to the fiduciary responsibility of those who manage nonprofit organizations may focus on such matters as the handling of nonprofit assets, the degree of personal financial responsibility assumed by individual members of governing bodies and staff of nonprofit organizations, and the breadth of responsibility board members have for other facets of organizational operations. Such laws may also consider restrictions on personal benefit, such as compensation limitations on members of governing bodies, standards for conflicts of interest and self dealing.

Some countries will choose to subject persons having fiduciary responsibility for nonprofits to the same general obligations as apply to persons acting in fiduciary capacity in the business sector, and issues of fraud or criminal conduct may be governed in general laws rather than laws specific to the nonprofit sector.

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<sup>21</sup> For a detailed discussion of private inurement and private benefit under U.S. law, see Hopkins, 1992, chapter 13; for a discussion of unreasonable compensation as private inurement/benefit, see U.S. Internal Revenue Service, 1992.

The common law has a number of useful principles developed in the law of trusts to guide those who hold fiduciary positions of trust and who administer funds in that capacity. While the concept of a trust is not used in the civil law, provisions developed in the common law of trusts to guide those who hold funds in trust for charitable purposes are useful conceptual bases to consider in the regulation of fiduciary duties and in developing standards for obligations to the public. Moreover, these provisions are subject to codification and in fact have been codified, for example in some laws in various states of the U.S. We consider these principles briefly here.

Historically under common law, judges of courts of law charged those responsible for the management of charitable organizations with three basic duties.

*Duty of care.* The first of these is known as the *duty of care*. Those in charge of the operation or management of a nonprofit organization, by whatever name such persons are known, e.g., directors or trustees, are entrusted with stewardship of assets for the benefit of the public served by the nonprofit organization. Directors must act with that level of care that a reasonably prudent person would use in similar circumstances. This duty requires not only reasonableness with respect to matters submitted to them for approval, but also reasonable inquiry and monitoring of affairs of the nonprofit and informed decision making.

*Duty of loyalty.* In addition to the duty of care is the *duty of loyalty*. Directors must avoid conflicts of interest and are absolutely prohibited from using their position to further their own private interests, as discussed in the personal benefit restrictions section above.

*Duty of obedience.* The last of the three duties of nonprofit board members is the *duty of obedience*. Directors are required to adhere to applicable laws and the terms of the nonprofit organization's governing documents, by whatever name known. Nonprofit organizations are often subject to a host of laws with which directors may not be familiar initially; for example, laws regulating charitable solicitation and fund raising, legislative and political activity, and unrelated business activities. There is also a need for those operating nonprofits to be familiar with other laws that may apply, such as laws on occupational safety and health or environmental regulation. The duty of obedience holds that directors must familiarize themselves with such laws and abide by them.

Under common law, a defense to alleged breach of these duties is the *business judgment rule* ("*BJR*"). To obtain the benefit of a BJR defense in any law suit, directors must have acted in good faith and with a reasonable basis for believing that their conduct furthered the organization's lawful purposes. In addition, directors must have exercised honest business judgment after due consideration of what they reasonably believed to be all relevant information. This rule recognizes that reasonable people may reach different conclusions on the same facts. What is required is that the action be reasonable in the circumstances.

Consistent with the BJR, it has been said that governing boards as a whole and directors as individuals achieve their optimal level of performance of duty when they exercise their responsibilities primarily by asking good and timely questions rather than by attempting to "run" programs or implementing their own personal policies or agendas.

After setting forth the rule that the operation of the nonprofit shall be vested in certain persons and then setting forth the duties of those in that position of trust, some laws may impose “personal liability” for wrongdoing in connection with a nonprofit organization, i.e., a person guilty of wrongdoing with nonprofit assets may be required to reimburse the nonprofit for any losses from his or her own assets. In many of the states of the U.S., so as not to discourage volunteer activity, laws are being adopted that limit the personal liability of volunteers, particularly where the entity itself carries certain minimum liability insurance.

Clearly, however, no law can tell a member of a governing body how to do that job well. This is where self-education and self-policing can play an important role in training volunteers and staff on their duties in their respective capacities. At a minimum, those who work with a nonprofit organization should at the start of their tenure be presented with the organization’s fundamental documents and become thoroughly familiar with them. They should also be eager to prepare and publish annual reports of activities and finances and to make certain that all legal requirements are met.

### Reporting and Disclosure Requirements

In addition to fiduciary standards, laws relating to nonprofit obligations to the public may also specify public reporting and disclosure requirements. These reporting and disclosure requirements may be in a separate law, or they may be consolidated with beneficial tax status administration. However structured, the purpose of such requirements is to provide a means of confirming, through periodic reporting and disclosure, that a nonprofit organization is in fact conducting activities consistent with its purposes and beneficial tax status and devoting its financial resources to the fulfillment of those purposes.

One common way of ensuring such openness is to require public access to certain records of a nonprofit organization, such as an annual report of activities or list of governing board members. Laws may indicate who has access to these records and under what circumstances. These measures are designed to enhance transparency and increase public confidence.

## **Issue 7: Business Activity**

In addition to their nonprofit activities, nonprofit organizations also often engage in a variety of “business” activities in order to generate income.

### Related vs. Unrelated Business

Broadly speaking, two types of nonprofit business activity can be distinguished: *related business* and *unrelated business*. Related business is commercial activity closely related to the fulfillment of the basic purposes of a nonprofit organization. For example, a nonprofit day care center that charges fees to at least some consumers of its services could be said to be engaged in a

“related” business. Similarly, a nonprofit university that operates a book store selling textbooks is also engaged in a “related” business activity.

An “unrelated” trade or business, by contrast, is one not closely related to fulfillment of the purposes of a nonprofit organization, or perhaps not related at all. For example, a nonprofit day care center that runs a laundry on the side can be considered to be operating an “unrelated” business, even if the income from the business goes to support the day care center. Definitions of unrelated income vary and many exclusions and exceptions are possible, such as exclusion of income from business conducted by volunteers or using donated goods, or in some cases, conducted for the convenience of patrons of a nonprofit, such as housing and cafeterias for university students or restaurants for patrons of a museum. Indeed, some laws regard any fee-for-service activity, even a related one, as in essence a business activity that is unrelated to the mission of the organization and treat only income from donations as “related” income.

Some decision must be made as to whether nonprofit organizations are to be permitted to conduct unrelated businesses at all, and if so, to what extent. In some contexts, there may be no other reasonable sources of income, so that conduct of unrelated business becomes a necessity.

Assuming the law permits the conduct of unrelated trade or business, there may be limits on the portion of income derived from, or activities devoted to, unrelated businesses or on the ownership of business subsidiaries. Consequences that may be incurred if these limits are exceeded can include fines, complete loss of beneficial tax status, and payment of regular income taxes.

### Source vs. Destination of Income

Even if unrelated business activity is permitted, important decisions still remain about how to treat it for tax purposes, particularly where nonprofit organizations themselves are exempted from all or some taxes. Broadly speaking, two approaches exist for resolving this issue.

The first approach is to focus on the *source* of the income, i.e., whether it derives from related or unrelated businesses. Thus, in some laws, related income is given the same beneficial tax status as other nonprofit income, while unrelated income, though permitted, is taxed in the same manner as the income of businesses. The rationale for this approach is that it puts nonprofit businesses on the same footing as for-profit businesses in the same field and thereby avoids charges of “unfair competition” from the business community. Even where this is done, of course, important issues still arise in determining taxable income from unrelated businesses due to varying methods of allocation of costs and overhead to unrelated activities (see e.g., Hansmann, 1989; Gjems-Onstead, 1994), and also from the use of tax deductible capital in the form of charitable donations to capitalize a business.

A second approach for dealing with nonprofit business activity focuses not on the source of the income, but on its ultimate *destination* (i.e., the purpose for which the income is used or destined). Under this approach, if the income is used for nonprofit purposes, then the source or activity that generates that income is irrelevant. Australian law, for example, employs this

destination principle and exempts from taxation income from any business activity--related or unrelated--so long as it is used for nonprofit purposes. This so-called destination principle was also in use in the U.S. until the 1950s when an "unrelated business income tax" was imposed on nonprofits.

There are many theoretical questions about whether failure to tax unrelated income (even if destined for nonprofit purposes) causes economic disparities and inefficiencies in the cost of raising capital and whether inequities result between nonprofit and for-profit organizations. The basic question for governments, however, is whether to leave open an important potential source of income for nonprofit organizations, whether to grant or withhold a tax subsidy for such income, and, if so, to what extent.

### **Issue 8: Other Funding Restrictions**

Because nonprofit organizations are frequently engaged in soliciting contributions from the general public, the possibility of fraud and abuse always exists. To reduce this, laws often impose a variety of restrictions or requirements related to such nonprofit solicitations and to other financial transactions in which nonprofit organizations may engage.

#### Solicitation of Funds

For the nonprofit sector to remain able to secure contributions, it is imperative that public confidence in the sector be protected. This can be done in part through the disclosure and private benefit restrictions noted above, through the adoption of voluntary codes of conduct, or even by incorporating higher-than-required standards in governing documents. At the same time, legal provisions are also sometimes considered necessary, particularly in the sensitive area of solicitation, to minimize the chances that charlatans will solicit funds for allegedly nonprofit purposes and then use the funds for illegitimate purposes to the detriment of donors and the nonprofit sector generally.

Such laws can take a variety of forms. For example, they can require registration of organizations or persons holding themselves out as professional fund raisers or fund solicitors before permitting them to solicit funds.<sup>22</sup> Such laws might also require accountability to donors and the public with respect to the use of funds. This may be accomplished through measures such as disclosing to donors the amount of funds collected and the portion of funds actually devoted to nonprofit purposes as opposed to being spent on fund raising or administrative activities. Alternatively, laws can establish a ceiling on fund raising or administrative costs such that these expenses may not exceed a certain percentage limitation (e.g., 15 to 35% of amounts received from the solicitation).

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<sup>22</sup> A "professional fund raiser" may be defined as "a person who for a flat fixed fee under a written agreement, plans, conducts, manages, carries on, advises or acts as a consultant, whether directly or indirectly, in connection with soliciting contributions for, or on behalf of, any [nonprofit] charitable organization", or several charitable organizations, but "who actually solicits no contributions as a part of such services." (Hopkins, 1991:258-259).

Laws may also consider means of making sure that gifts solicited or given for particular purposes are used for the purposes intended by the donors. This can be done by requiring that organizations secure advance approval from some public or private agency for major solicitations. Under such a system, organizations must disclose their identity, their purposes, the purposes for which funds are being solicited, how much is to be solicited, who will conduct the solicitation, the amount of anticipated costs of the solicitation, and confirmation that they are currently in compliance with applicable laws. On this basis, a license to solicit is then issued for a stated period. Typically there are exemptions to such laws for solicitations by church organizations of their congregations, by membership organizations of their members, and by schools and colleges of their alumni.

Such solicitation laws are quite prevalent at the state government level in the U.S. (Hopkins, 1991). They have received much attention due to multi-million dollar scandals where television evangelists solicited money for allegedly religious purposes, but in fact used the funds to support lavish lifestyles.

#### Other Financial Restrictions

In addition to the solicitation restrictions, legal provisions can also be made for other facets of nonprofit financial operations. Thus, in some instances, regulatory authorities can require that generally accepted principles of financial accounting for nonprofit organizations (developed jointly by the accountancy profession and a governmental agency) be used by nonprofits to prepare their financial statements.

In addition, other laws may also come into play. For example, in the U.S., some types of gifts, such as charitable gift annuities, may involve insurance and securities regulation laws. In the charitable gift annuity transaction, an individual makes an irrevocable transfer to charity of property such as securities. The charity contracts to pay the donor or other beneficiaries a guaranteed annuity for life. Because the property transferred has a value larger than the value of the annuity, the transaction is in part the purchase of an annuity and in part a contribution. If this type of gift is permissible in a particular country, consideration may be given to its regulation under other generally applicable bodies of law (such as insurance company law), or under laws designed for the nonprofit sector.

Finally, to make any of these restrictions effective, laws must include enforcement mechanisms as well. For example, some laws may establish civil or criminal penalties for misdeeds of directors or fraudulent solicitation or solicitation without complying with registration requirements. At the same time, as noted earlier, laws can relieve volunteers of liability for unintentional wrongdoing in this capacity as board members of voluntary organizations.

## Issue 9: Political Activity

The roles of “advocate and improver of social systems, empowerer of citizens, and critic and monitor of government policies and programs” are widely viewed as crucial functions of the nonprofit sector (Chisolm, 1987-1988:205, 27-29). Thus legal restrictions on these roles must naturally be approached with great care. Nevertheless, some legal structures, particularly those in the common law tradition, place limits on certain facets of nonprofit involvement in political activity (Randon and 6, 1994:27).

Underlying such restrictions is the belief that government should not underwrite participation in political debate, particularly partisan political debate, but should remain neutral, and that taxpayers should not be required to finance, through tax subsidies, views with which they disagree (Chisolm, 1987-1988:249). To the extent that nonprofit organizations and contributions to them enjoy beneficial tax status, the involvement in direct political activity by such organizations can be construed as indirect public support for such political activity. To the extent that such concerns are present in a country, the great challenge is to frame laws that limit objectionable forms of political involvement on the part of nonprofit organizations without in the process destroying the ability of such organizations to perform their important advocacy functions.

### Forms of Political Activity

One mechanism for doing so is to differentiate among several different types of “political” or advocacy activity. Three such types can usefully be identified: (a) *political campaign activity*; (b) *lobbying*; and (c) *policy advocacy*.

(a) *Political Campaign Activity*. Political campaign activity generally refers to activity designed to influence the outcome of campaigns for public office. This type of activity raises the most serious public policy questions since it presents in the most direct form the phenomenon of public subsidies being used to affect the prospects of particular candidates for public office. In the U.S., therefore, nonprofit organizations that qualify for tax deductible charitable donations are absolutely prohibited from engaging in such political campaign activity and subjected to severe penalties if they do.<sup>23</sup>

(b) *Lobbying*. A second type of political activity involves not promoting or opposing particular candidates for public office but promoting or opposing the passage of particular pieces of legislation under consideration by some legislative body. Here, again, concerns about the use of public funds to subsidize particular political views may lead to limits on the extent to which

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<sup>23</sup> If a nonprofit charitable organization makes an expenditure for a political activity it may lose its tax exempt status. If it does so, it is ineligible for tax exempt status as any other type of nonprofit organization. It may also be subjected to an excise tax on “political expenditures.” The initial tax is 10% of the amount of the expenditure, and a tax of 2.5% is imposed on the organization’s managers (such as directors and officers) where it was known at the time of the expenditure that the expenditure constituted a political expenditure. If the initial tax was imposed and the expenditure was not corrected in a timely manner, i.e., any recoverable amount was not recovered, safeguards were not put in place to prevent future political expenditures, etc., a further tax is imposed at 100% of the amount of the political expenditure. Other penalties can be imposed as well. IRC §§501(c)(3) and 4955.



nonprofits that receive favorable tax treatment can engage in such lobbying activity, whether it takes the form of direct communication with legislators or indirect communication through attempts to influence the opinion of members of the public toward particular pieces of legislation. Thus, in the U.S., nonprofit organizations that are eligible for receipt of tax deductible contributions are not permitted to devote a “substantial part” of their activities to such lobbying or influencing legislation. While the definition of “substantial part” is far from clear,<sup>24</sup> this limitation discourages many nonprofit organizations from active involvement in the legislative process and encourages those that wish to engage in such lobbying to establish special subsidiaries that are nonprofit but not “public benefit” in character.

(c) *Policy Advocacy*. Even where campaign activity and direct involvement in the legislative process are constrained by law, it may still be possible to leave unfettered a substantial area of nonprofit involvement in policy advocacy more broadly conceived. Such advocacy can take a myriad of forms, including conducting and publishing research on important problems being overlooked in public policy, educating the public and elected leaders about such problems, engaging in peaceful assembly or free speech to protest or promote government actions, conducting seminars and distributing materials, and a host of other related activities. These activities can be vitally important in bringing new issues to the attention of the public and government though they stop one step short of direct lobbying. As such they may raise fewer of the concerns that lead to constraints on nonprofit lobbying or on nonprofit participation in campaigns for public office.

### Types of Nonprofit Organizations

In addition to differentiating among types of nonprofit activities, laws on nonprofit political involvement can also differentiate among types of organizations to which political limitations apply. Logically, the distinctions that make sense here are the ones that correspond most closely with the tax laws that are in effect. Since the major objection to having nonprofit organizations engage in political activity is that such activity constitutes a form of government subsidization of private political decisions, the restrictions can usefully be limited to the organizations that receive the greatest subsidies. In the common law tradition, for example, the limitations on political activity apply most directly to public-benefit organizations, which are eligible to receive tax deductible gifts from the general public. By contrast, mutual benefit organizations can engage in lobbying activities without limitation. While there is a certain irony in this, since the public-benefit organizations may have the most interest in general public-interest questions, their substantial tax advantages make it seem somewhat inappropriate for them to be too directly involved in affecting the policies and

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<sup>24</sup> What constitutes a “substantial part” has been the subject of much controversy with the U.S. Internal Revenue Service and in the courts. Whether legislative activity rises to the level of a “substantial part” is a test of facts and circumstances, where often an attempt is made to measure the percentage of the organization’s spending allocable to its efforts to influence legislation. Because of the difficulty with the term “substantial part,” nonprofit charitable organizations that engage in legislative activities often find it preferable to elect to be governed by a newer test based on expenditures for legislative activities. The newer test is based on permitted level of expenditures, called the “lobbying nontaxable amount,” beginning with 20% of the first \$500,000 of an organization’s expenditures for tax exempt nonprofit charitable purposes, 15% of the next \$500,000, 10% of the next \$500,000, and 5% of any remaining expenditures, not to exceed a total amount spent of \$1 million. See IRC §§501(h) and 4911(c)(2); Treas. Reg. §§1.501(h)-3(c)(2) and 46.4911-1(c)(1).

personnel of the government that helps finance them. Thus, in the U.S., it is only the public-benefit nonprofits, the 501(c)(3)'s, that are limited in their involvement in lobbying activities.

### **Issue 10: Key Trends**

In addition to the nine broad issues confronting drafters of nonprofit laws that have been outlined above, the nonprofit sector faces enormous changes in the years ahead that may also pose legal challenges for the sector. In this section we identify some of the most salient of these changes and note some of the challenges they pose to nonprofit law.

#### Growth and Diversification

Perhaps the central trend affecting the nonprofit sector around the world is the vast expansion of the demands being placed upon it and the resulting enlargement of its role and diversification of its basic structure. A veritable “associational revolution” appears to be under way at the global level, as citizens and policy makers have begun looking to nonprofit organizations to help resolve the multiple crises of the welfare state, development, socialism, and the environment (Salamon, 1994b). As a consequence, the scope of the nonprofit sector has expanded massively and its internal differentiation grown significantly.

Inevitably, this growth brings with it immense challenges of sectoral definition. Laws designed to accommodate charitable institutions providing relief to the indigent must be rethought in the context of organizations seeking to help the poor start their own businesses. Are the latter business enterprises and thus not entitled to the tax and related privileges accorded charitable institutions? Or are they really charitable institutions pursuing their missions through a different route? Increasingly, nonprofit law must come to terms with a far more diverse set of institutions and purposes.

#### Government-Nonprofit Relations

One of the principal factors helping to explain the expansion of the nonprofit sector on the global level is the increasing tendency of government to turn to nonprofit organizations to assist it in carrying out a wide variety of functions, from the provision of social welfare to the promotion of economic development. As citizens and political leaders alike have come to question the wisdom of sole reliance on government to meet the social welfare and development demands they face, attention has turned to mechanisms for forging partnerships between the state and the voluntary sector. Elaborate contractual relationships have consequently been forged between governmental authorities and nonprofit institutions in countries throughout the world, and the likelihood is that these relationships will grow in importance in the years ahead. In the process, important new legal challenges will arise as both government and the nonprofit sector search for ways to cooperate with each other while still retaining the features that make each distinctive. Thus, new contracting arrangements, vouchers, reimbursement systems, and provisions for sorting out indirect costs will come to the fore and demand legal resolution.

### Commercialization

In their efforts to respond to pressing needs, as suggested above, nonprofit organizations will also increasingly turn to fees and charges for their activities and enter a variety of businesses to raise funds for their programs. In the process, they will come into increasing contact with private businesses operating in the same or related fields. The result will be increased demands for legal definition of the borders between these two sectors. Already such demands are widespread in the U.S., leading to a frontal assault on the whole concept of a nonprofit sector in some quarters. It seems reasonable to assume that similar challenges will arise in other settings as well. This will intensify the concerns about nonprofit business activity identified earlier and raise new questions about the treatment of even the “related” business income that nonprofit organizations receive.

### New Forms of Private Giving.

Another striking trend likely to affect the nonprofit sector around the world is the expansion of new forms of giving to nonprofits. Increasingly, giving is becoming institutionalized and planned. Impulse giving and collection box giving is being joined increasingly by “planned giving” involving charitable remainder trusts, charitable annuities, and other complex forms of contributing to charities. The U.K. has even established “charity card,” a kind of charitable credit card with which donors can charge their charitable gifts. As these new forms of giving gain currency, legal structures will need to be adapted to make room for them.

### Professionalization and Formalization of Ethical Standards.

As nonprofit organizations come into greater contact with both government and the business sector, new demands will arise for attention to the ethical standards under which these organizations operate and the level of professionalism they bring to their work. This will in turn stimulate debates about the relative virtues of *self-regulation* vs. *government regulation* to ensure that nonprofit institutions abide by the highest ethical standards and carry on their activities in a professional fashion. To the extent that nonprofit organizations recognize these demands and respond accordingly, cumbersome regulatory controls can be avoided. Given the peculiar character of this set of institutions, this would be a highly desirable outcome. However, it seems likely that legal action will be required in numerous circumstances as well, if only to guarantee openness and accountability.

### Globalization.

Finally, the nonprofit sector seems likely to face increased demands of globalization and cross-national activity as a product of the broader globalization of the world economy, worldwide disillusionment with governmental capacity to deal with problems, a general decline in public sector resources, the dramatic and historic collapse of communism, the increasing prominence of multinational corporations, and the growing globalization of many of the issues with which nonprofits have been concerned, such as the environment and health.

To cope with this new development, the law of nonprofit organizations will have to become increasingly international in the years ahead. Thus, for example, more favorable legal provision will have to be made for cross-national grantmaking and for nonprofit organizations in various countries to operate across national borders. Drafters of nonprofit law, no less than drafters of laws for commercial activity, must be increasingly sensitive to the international dimensions of the activity they are regulating and therefore increasingly aware of the range of national treatments in this field.

### **Conclusion**

The ongoing nonprofit “revolution” requires changes in the law in just about every country. Some countries have the opportunity to start afresh, developing laws for regulation of the nonprofit sector based on a sampling of the best the world has to offer, adapted to local conditions and traditions. In so doing, they must resist the temptation to assume that any existing model contains the right mix of features that are appropriate to the new context (Bromley, 1994). Rather, important work needs to be done to fashion a new international model containing key elements that could be the subject of treaty or other international agreements.

While the details of such a law will need to be developed in line with national traditions, the goal legislative drafters everywhere may wish to consider is to create legal systems that allow the start of nonprofit organizations as a matter of right upon compliance with a limited set of statutory formalities and that guarantee these organizations a significant degree of autonomy and independence. Purposes should be stated broadly and in a flexible manner. Beneficial tax status should be a matter of right for entities organized and operated for appropriate purposes set forth in the law. Reporting should be significant enough to allow openness, transparency and monitoring by public and government alike, but not be overly burdensome or intrusive. And cross-border giving and nonprofit activities should be facilitated through mutual recognition by treaty. All of this should ideally operate in the context of the rule of law with independent courts to provide meaningful enforcement of rights where necessary. Laws drawn or revised in this manner will contribute to the growth of a truly effective international nonprofit sector.

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