The Legal Framework of the Nonprofit Sector in the United States

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Non-profit, non-business, non-governmental are all negatives. One cannot, however, define anything by what it is not. What, then, is it that all these institutions do? They all have in common—and this is a recent realization—that their purpose is to change human lives [Drucker, 1989, p. 198].

Several years ago at a legal conference in Moscow, I was approached by a Russian lawyer who was trying to make sense of the interplay of laws that govern the charitable sector in the United States. What was needed, he suggested, was not more detailed treatments of state corporation and trust laws or federal and state tax laws pertaining to the charitable sector. What was missing, he said, was an overview with practical detail, a "bird's-eye and worm's-eye view" of U.S. charitable law. This chapter is based on the paper I wrote in response to that request. It takes the form of a case study and commentary featuring a hypothetical charitable advocacy organization which, although fictional, is a composite of many existing organizations. The case study provides the basis for the subsequent commentary on legal and regulatory issues that are frequently encountered during the life cycle of a charitable organization in the United States. To allow consideration of a broad range of legal issues, the case study considers the growth and development of a large and successful charitable organization.
Jim and Beth Rankin received their doctorates in oceanography in 1965. After graduation, they taught marine science at neighboring universities and conducted academic research. They formed a discussion group with their colleagues, which met weekly. In the first year, the group included about twenty people who discussed their research findings about the ocean environment. It soon became apparent to the members of the group that the oceans were threatened and that citizens as well as social institutions, including the federal and state governments, were blissfully unaware of the threat and its significance. Existing environmental organizations were concerned with other issues pertaining to land and air and had not yet begun to consider marine issues.

In 1967 the Rankins decided to do something about the problem. They expanded their discussion group to fifty members, and they enlisted the aid of their colleagues in giving speeches about the environmental threat to the oceans to any local organizations that would listen. Their goal was clear and entirely lacking in modesty: to change the attitude and behavior of people toward the oceans. Changes in the policies of government and business, they believed, would follow in time.

The Rankins began to encounter a pleasant but persistent problem. After they gave a speech, members of the audience would ask where they could contribute money to support their work. By this time, the Rankins had come to think of themselves primarily as organizers rather than as academics. They decided to form a new nonprofit environmental organization to protect the oceans.

**Formation**

**Name.** The Rankins wanted a name that was dramatic. They considered many names and settled on the international distress signal, SOS, as an acronym for Save Our Seas, only to learn that another organization in a distant state was already using that name. They kept returning to the idea that the problem was global in scope and that water comprises more than two thirds of our planet. Late one night the name came to them: Planet Water.

**Incorporation.** With the help of an attorney, Planet Water was incorporated in California in 1969 as a nonprofit corporation. Its purpose, as stated in its articles of incorporation, is to encourage and promote the environmental protection of the oceans. The articles were signed by the Rankins and were mailed to California's secretary of state for filing. Within a week, the Rankins were notified that the document had been accepted and filed. They opened a bank account for Planet Water with $1,000 that they had managed to save from their salaries.
The bylaws of Planet Water provide for a voting membership of all individuals who pay dues. They also make provision for a fifteen-person board of directors elected by the members for three-year terms.

**Tax Exemption.** Next, Planet Water applied simultaneously to the Internal Revenue Service and to the California Franchise Tax Board for federal and state tax exemption as a charitable organization.

In those applications, the Rankins described the purpose and intended activities of Planet Water and included a proposed budget listing the anticipated receipts and expenditures of Planet Water for the next three years. The California Franchise Tax Board exemption was issued in two months. Three months later the IRS exemption was in hand.

**Operation**

**Program.** Since its formation, Planet Water's activities have become extensive. All are reviewed each year by its board of directors. Old programs are continued or dropped, and new ones added, and all are tested by whether they advance the goals of oceanic environmental education and constituency building.

Research has become an important component of its program. Planet Water has designed and is conducting a five-year study of San Francisco Bay and of Chesapeake Bay for the purpose of developing a scientific baseline against which to measure the environmental health of those bodies of water. Both studies are funded by the federal government.

Planet Water conducts an extensive public education program. It offers a training course in marine environmental policy issues for volunteers. There are about 425 volunteers, each of whom makes a commitment to give ten speeches a year. Planet Water publishes, in seven languages, a quarterly magazine and widely popular books that are filled with handsome photographs and informative articles on ocean themes. It has produced numerous related television programs.

Children are not overlooked. Planet Water publishes an ocean science curriculum for elementary school teachers. It commissions and publishes books for children designed to acquaint them with the world's oceans, and each summer it operates a sea camp for children at eight coastal locations. After a flurry of publicity in the national press about the killing of dolphins, Planet Water launched an "adopt-a-dolphin" campaign, which has resulted in the formation of Dolphin Clubs for schoolchildren across America.

Active in lobbying nationally and internationally, Planet Water has been credited with contributing significantly to the International Whaling Commission's global ban on whaling and the enactment of the Clean Water Act and the Ocean Dumping Ban Act.

Planet Water also makes modest grants in support of water-related environmental activities of other groups, both foreign and domestic.
Membership. Planet Water now has 300,000 members worldwide, who pay annual dues of $25. They receive a quarterly magazine and are invited to attend the annual meeting at which the Rankins, who serve as co-executive directors, report on the current status and future prospects of Planet Water. It has chapters in major coastal cities in the United States and affiliates in twelve other countries. Members vote by mail for directors to fill terms that have expired.

Governing Body. The governing body of Planet Water is its board of directors. Except for the Rankins, who are paid as staff members and who have been elected to the board on a continuing basis over the years, the fifteen board members serve without compensation. They are, however, reimbursed for their travel, meal, and lodging expenses in connection with attending board meetings. The board meets quarterly, in January, April, July, and October. At the July meeting the board reviews the goals and objectives of the organization and makes, usually on recommendation of the Rankins, the modifications it believes to be suitable. At the October meeting, the board reviews and approves the program and financial budget for each quarter of the next year. At the following year's meetings, the primary task of the board, apart from developing the budget for the new year, is to review the program and financial performance of the organization in comparison with the budget, to consider policy issues put before them by the co-executive directors, and to approve grants.

Between board meetings, policy decisions are made by an executive committee consisting of the four officers who are also board members. The day-to-day management decisions are made by the Rankins in accordance with the program and financial budget approved by the board of directors.

Staff. The paid staff of Planet Water now consists of 312 people, ranging from accountants to zoologists. When employees are hired, they are given three documents: a letter containing a description of their duties and their salary, a personnel policy describing the health plan and retirement and other benefits, and an evaluation form. Each year the board of directors reviews and sets the salary and benefits for the Rankins.

The compensation for all other employees is decided annually by the co-executive directors, subject to review and approval by the board. In determining the appropriate amount of salary and benefits, the Rankins rely on an annual compensation survey published by a national nonprofit management organization. From that survey, they determine the range within which other nonprofit organizations of comparable size pay their employees for performing comparable tasks. The amount paid to the employee within that range by Planet Water will depend upon how well the employee has fared in the evaluation.

Finances. The finances of Planet Water, which were precarious indeed at the beginning, have now stabilized. Its annual revenues are about $20,000,000,
made up of dues and fees (40 percent), book sales (16 percent), individual contributions (13 percent), government contracts (8 percent), royalty income (7 percent), investment income (6 percent), joint venture income (5 percent), foundation grants (4 percent), and corporate contributions (1 percent).

Dues and fees are paid by members and participants. At $25 each, 300,000 members generate dues of $7,500,000. Parents of the 2,000 children who attend the summer sea camp pay a fee of $200.

The source of the income from book sales is Planet Water's extensive program of publishing educational books on the ocean environment.

Individual contributions are derived mainly from direct mail campaigns. Each year, Planet Water conducts four campaigns, reaching 20 million households. The core of the solicitation for funds is often a copy of a recent Planet Water advertisement in the New York Times dramatizing the consequences of an oil spill or other environmental catastrophe at sea. Over the years, as the public has learned more about the effective work of Planet Water, the amount of bequests has also increased.

The government contracts include, in addition to the bay studies, the designation of Planet Water as portkeeper of four coastal ports, to monitor compliance with restrictions on the discharge of pollutants into the waters of those ports by shipping, industry, and local governments.

Planet Water receives extensive royalty income. It licenses the use of its name and logo to approved manufacturers of over 100 products, ranging from t-shirts to windsurfers, in return for a 3 percent fee or royalty based on the gross receipts from sales.

Planet Water's fund balance is now $5,000,000. Investment decisions are made by the board of directors on recommendation of the finance committee. The funds of Planet Water available for investment are allocated equally among four outside investment managers. Once a year, the committee meets with its advisers to review their investment performance. The board of directors has instituted a policy of replacing, every third year, the investment adviser with the poorest performance record.

Planet Water is also engaged in a joint venture with a commercial organization. They are partners in the design, manufacturing, and marketing of submersible vehicles that are used to gather data on pollution beneath the ocean surface. The vehicles are also sold to the public for recreational use.

Grants from foundations have increased each year, although they remain a small percentage of overall receipts. The amount of corporate contributions has not improved in recent years.

**Compliance**

Each year Planet Water must submit reports to tax and regulatory agencies. Annually, at the federal level, Planet Water must file a report with the Internal Revenue Service, setting forth its receipts and expenditures, explaining the general nature of its activities, disclosing the name of each large contributor and each director, officer, top official, highly compensated
employee, and consultant. The report discloses the salaries and benefits provided to highly compensated employees.

Each year, at the state level, Planet Water must file similar reports with the California Franchise Tax Board and the Registry of Charitable Trusts. Also, it must disclose the names of its current officers to the secretary of state.

At the local level, Planet Water must file an annual form with the City and County of San Francisco, to qualify for an exemption from property tax on any land, buildings, and office equipment that it owns in San Francisco. Planet Water must describe the nature of its property and explain how it is used in carrying out its charitable purpose.

Each quarter during the year, Planet Water must file with federal and state tax authorities a form that describes the amount of income and other taxes it has withheld from the salaries of its employees and paid to the tax authorities.

Finally, Planet Water must comply with separate charitable solicitation laws imposed by most states and by some cities, which require that all charitable organizations that raise funds in their area must register and report on a periodic basis with the appropriate authority.

**Termination**

The board of directors does not plan to terminate Planet Water. The directors believe there is a continuing need for its work. Its goals, they have concluded, are not likely to be realized in the foreseeable future.

In a recent interview, Beth Rankin was asked how she would know when Planet Water had accomplished its mission. "No one is more aware than I am," she said, "that the changes in public attitudes toward the environment have not been due solely to our modest efforts. We happened upon an idea whose time had come. On the other hand, I am convinced that we have made some difference. But there is still a long way to go. I will know that we have reached our goal," she concluded, "when the act of polluting water that belongs to everyone is every bit as socially unacceptable as fouling the water you serve in your own home."

**Commentary**

**Pre-Formation**

For several years, the Rankins met regularly with colleagues and gave speeches about environmental threats to the oceans. In many countries, such meetings and public speeches would be regulated by government. In America, however, the Bill of Rights to the U.S. Constitution limits government regulation of speech and the related right of association. Private meetings and speech may not be regulated. Public speech and meetings may not be regu-
lated as to content, but reasonable restrictions as to time, place, and manner may be imposed. The early environmental activities of the Rankins and their colleagues, therefore, proceeded lawfully, despite the absence of government knowledge or authorization. Government involvement did not occur until the Rankins decided to conduct their activities within a formal legal entity.

**Formation**

The Rankins were not required to form a charitable organization, or any organization at all, in order to advocate for environmental preservation. It was, rather, the benefits of charitable status and the corporate form that led them to choose this approach. Had they wanted to operate without governmental oversight and without legal formalities, they would have been entirely free to do so, but they would have had to forego the accompanying benefits. The benefits are both symbolic and practical. A formal organization would have its own separate identity, which would symbolize their mission and could survive their retirement or death. Moreover, the corporation, rather than the Rankins as individuals, would be legally responsible for the project's acts and omissions.

The tax benefits of forming a separate charitable organization are even more significant. A tax-exempt charity, as the name implies, generally pays no tax on its income. Of equal importance, charities may offer potential donors not only the satisfaction of contributing to a good cause but also the ability to lower their income tax bills. This is because individuals and corporate taxpayers who contribute to charitable organizations may, under the federal tax system and those of many states, reduce, by the amount of their contributions, the income base on which their tax is calculated.

The formation of legal entities is regulated, in almost all instances, by state law rather than by federal law. In California, the Rankins would have three legal entities to choose from: a nonprofit public benefit corporation, a charitable trust, or an unincorporated nonprofit association. The association form is seldom used, because its few rules contain little protection against liability and leave many operational questions unanswered. The nonprofit corporation has largely replaced the more ancient legal form, the charitable trust, as the entity of choice for new nonprofit organizations. This has come about because charitable trusts are largely creatures of case law, while nonprofit corporations are creatures of statutory law. Modern statutory rules governing organizational formation, operation, and termination contain protections against liability and provide comprehensive legal guidance to the directors and members of nonprofit corporations but not to trustees of charitable trusts.

Name. The Rankins were not able to use their initial choice of name, SOS, because another charitable organization was already using it. Had they at-
tempted to use that name, both the government and the other charity could have taken steps to prevent it.

No state will allow the formation of a new corporation whose name is deceptively similar to that of another organization. Moreover, the civil law of unfair competition allows an existing organization to prevent a new organization from using a name that exploits the value which the prior organization has given to the name. To avoid name-related problems, new organizations commonly search the state corporation registry and, with increasing frequency, the federal trademark registry as well, before a name is finally chosen. After the name has been chosen and the organization has been formed, registering that name for protection under the federal and state trademark laws is becoming standard practice.

Incorporation. A common term for the enabling document of a nonprofit corporation in the United States is "articles of incorporation." State practice varies, however, and other terms (such as "constitution," "certificate," "charter," and "organic document") are still encountered.

In California the content of articles of incorporation is largely standardized by statute. Articles generally contain the name of the organization, the law under which it is being incorporated (for example, the Nonprofit Public Benefit Corporation Law), its purposes, the manner in which the net assets are to be distributed in the event of dissolution, and the name of the incorporator or incorporators. California law requires only one incorporator. However many incorporators there are, they need not be U.S. citizens or even residents.

The incorporator submits the articles to the secretary of state, together with the minimum state income tax prepayment (which is refunded, with interest, if the corporation later receives tax-exempt status). The secretary of state reviews the articles of incorporation for form, but not for content. If the articles are correct in form, they will be accepted for filing and given a corporate number. The corporation's legal existence begins on the date on which the articles are accepted for filing by the secretary of state.

Once the articles have been filed and returned, the individuals who have incorporated the organization then adopt its bylaws. The bylaws prescribe the organizational rules that, so long as they are not inconsistent with state law, govern the corporation. They usually contain various sections describing the board of directors (its powers, the term of office and manner of election of the directors, and the rules for conducting meetings), the members, if any (their rights and duties and rules for members' meetings), the duties of officers, and other similar matters relating to the formal government of the corporation. At the same meeting, the incorporators will usually elect the first board of directors and the officers and authorize the opening of a bank account, specifying which individuals have authority to withdraw funds.

The next step is, commonly, to visit the local office of a bank and to
open the new charity's bank account. Banks generally require evidence of the organization's legal existence (here, the file-stamped articles) and of the connection between the organization and those who will manage the bank account (usually, a resolution adopted by the board of directors appointing signatories on the bank account).

State law requires that minutes—a written record of a meeting—be made of all meetings of the organization's board of directors and committees. There is no requirement that the minutes be filed with any governmental agency. They must be produced, however, if they are requested in connection with any audit of the organization by a governmental agency.

The bylaws are effective as soon as they are adopted by the incorporators. It is not necessary to obtain the approval of any governmental agency.

Tax Exemption. The revenues of nonprofit organizations are generally exempt from federal income tax. Business revenues are a major exception. If the nonprofit organization is actively engaged in a business whose conduct is unrelated to its exempt purpose, then it is taxable on the net receipts from that activity at the same rates that apply to a business corporation. There are many exceptions and exclusions, however, to the scope and coverage of that complex tax. It does not apply, for example, to passive investment income, such as most types of dividends, interest, rents, and royalties.

California law is substantially the same: a nonprofit organization is exempt from state income tax except on its unrelated business income. In both jurisdictions the exemption process entails the filing of an application for exemption and a review by the tax agency of the proposed purposes and activities of the nonprofit organization. It is in this review that the content of the charitable organization is scrutinized for the first time by any governmental agency.

The exercise of discretion by the Internal Revenue Service is reviewable internally and in court. Federal law gives an organization extensive opportunities to challenge a proposed determination by the IRS that it fails to qualify as charitable. The initial determination is usually made at a regional office of the IRS. The organization may appeal the adverse proposed determination administratively, within the IRS, at the regional and national levels. If those appeals do not succeed, the organization may file an action in federal court, where a neutral judge will review the administrative proceedings and make an independent determination as to whether the organization qualifies as charitable.

When Planet Water applied for tax-exempt status, it represented to the Internal Revenue Service and the Franchise Tax Board that it fit the statutory definition of a charitable organization. The statutory definition (contained in a federal statute—Section 501(c)(3) of the Internal Revenue Code—and, also, in corresponding provisions of the laws of many states) requires that a tax-exempt charitable organization be formed only for certain permitted purposes: religious, charitable, scientific, testing for public safety,
literary, educational, fostering national or international amateur sports competition, or the prevention of cruelty to children or animals. It must be organized exclusively for one or more of those purposes; that is, its governing document must limit its activities to proper goals. And it must be operated exclusively for one or more of those purposes. Thus, it may not engage in activities that serve other purposes, except to an insubstantial degree.

The federal statute explicitly prohibits certain activities by tax-exempt charitable organizations. No part of a charity's net earnings may be regularly diverted to the benefit of any private person or entity. This means that the charitable organization's funds must be used to carry out its charitable program and may not be paid to individuals except as reasonable compensation for necessary services performed for the charity or as fair and reasonable payment for the use or acquisition of property required by the organization.

The federal statute bars a charity from engaging in electioneering—activity in support of, or in opposition to, a candidate for public office—and it also provides that no substantial part of a tax-exempt charity's activities may involve attempts to influence legislation. Except for churches, charities that are broadly publicly supported (as opposed to charities that are supported chiefly by a single family or business entity) may make expenditures to influence legislation amounting to 20 percent of their total expenditures in any taxable year, subject to a maximum of $1,000,000 per year for the largest organizations. Since Planet Water intended to work for the passage of proenvironment legislation, it notified the Internal Revenue Service, in its application for tax exemption, that it would engage in lobbying activity to the extent permitted by law.

Although American tax-exempt charitable organizations are subject to these limits on their political activity, they are nonetheless free to engage in activities that, in many other countries, would be considered political indeed. For example, Planet Water has sponsored rallies, parades, and other law-abiding demonstrations opposing the pollution of the oceans. It regularly buys full-page advertisements in major newspapers to advocate its views. It has led international consumer boycotts of products that endanger marine life. The activities of Planet Water in attempting to change the attitudes and behavior of all sectors of society—business, government, nonprofit, and citizens—are intended to target power relationships between and within those sectors. Its activities are political in the most fundamental sense. So long as it refrains from involvement in campaigns for public office and complies with the limits on its lobbying expenditures, however, the political activities of Planet Water—like those of other American charities—are limited only by the willingness of its supporters to finance them.

**Operations**

**Program.** Planet Water receives donations from the public and grants from other charities, but most of its income is generated by its own activities,
including publications and government contracts. It is entirely legal and proper in the United States for a charitable organization to charge a reasonable fee for goods or services it provides. However, its activities must be conducted in a noncommercial manner, and the conduct of those activities (not just the use to which the proceeds are put) must be substantially related to the accomplishment of the charity's exempt purpose. If not, the organization may be taxed on the proceeds of the activity at corporate rates. Furthermore, an organization's tax exemption may be revoked if its unrelated business activities are so extensive in comparison with its charitable activities that the organization fails to carry out a charitable program reasonably commensurate with its financial resources.

During its annual review of Planet Water's programs, the board of directors examines each program to determine whether it satisfies these standards. In considering Planet Water's magazine, for example, the board determined that the magazine helps Planet Water to advance its educational purposes by informing a wide audience about marine issues. But is it improperly commercial? Like many commercial publications, the magazine is well designed and filled with color photographs. But these graphic techniques help the magazine to convey its message more effectively. The magazine is distributed through conventional commercial channels, including subscriptions and newsstand sales. But it is also made available at reduced rates to schools, libraries, and other public facilities. Moreover, the board has decided to continue to distribute foreign language editions of the magazine, even though their costs far exceed the revenues derived from them, in order to reach a global audience with information about the global problem of marine pollution. The board concluded that publishing and distributing the magazine contributes substantially to the accomplishment of Planet Water's exempt purposes and that the magazine is not operated in a commercial manner.

In a market economy, the success of a business enterprise depends not only on the decisions made by its directors, officers, and staff, but also on whether investors are willing to risk their money on the enterprise and on whether consumers are willing to buy the goods or services it produces. The economic dynamics of much of the charitable sector are similar. Planet Water will survive only if the public supports it, whether with volunteer time, donations of money, or purchases of the educational materials and services that Planet Water provides. Planet Water's staff and board, therefore, are constantly concerned with improving Planet Water's performance and level of response of the public in the organization itself, as well as in the marine issues it advocates.

In recent years, Planet Water has received, with increasing frequency, requests for grants from individuals and other smaller and sometimes informal environmental groups. After extensive consideration, the board of directors decided that an important part of Planet Water's mission was to support informal citizen-based environmental activity related to the oceans. The
board agreed to set aside 5 percent of Planet Water's annual revenues to fund this effort. Each year the board grants a total of $1,000,000, usually in amounts of $5,000 or less.

Planet Water has adopted a written grants procedure which provides that it will consider proposals for support of emerging charitable organizations and informal groups engaged in activities to preserve oceans, lakes, and rivers. The written proposal must describe the problem to which the organization or group is responding, and it must also contain a description of the activities the grantee intends to conduct, including a budget that shows, in detail, how the money requested will be spent to carry out those activities. The staff of Planet Water reviews all proposals received and recommends to the board of directors those that it believes should be funded. The Board considers them at its quarterly meetings. Planet Water receives far more proposals than it is able to fund, even with $250,000 available each quarter. Last year, the staff recommended to the board only one out of every ten proposals it received. The board, in turn, funded about 80 percent of the proposals recommended to it by the staff.

Once a grant is approved, the staff sends a letter to the grantee, advising it of the grant award and enclosing a check. The grantee is required to submit periodic written reports to Planet Water, explaining how the grant is being spent and how those expenditures are consistent with the representations made by the grantee in its proposal.

When Planet Water received its federal tax exemption as a charitable organization, it also was classified by the IRS as a public charity, based on its representation that it would have a broad base of financial support. As a public charity, Planet Water is not limited in making grants to organizations that have achieved formal recognition of their charitable and tax-exempt status. It may make grants to support any activity that furthers its own charitable purposes, whether that activity is conducted by a formal charitable organization, an informal group, a business, or an individual. If the grantee is not a formal charity, however, Planet Water must restrict the grant to charitable purposes and must require written reports so that it can be assured that the grant was used for a proper charitable purpose and not for a personal or business purpose. So long as it adheres to these standards, Planet Water may make grants abroad as well as in the United States.

Membership. Planet Water's bylaws provide that a member of the corporation is anyone whose current dues are paid. Over 300,000 people around the world have paid their annual dues for the current year and have the right, under the bylaws, to vote for members of the board of directors. They also receive Planet Water's magazine.

Planet Water is not required by law to have voting members. California law permits a public benefit corporation like Planet Water to operate with only a board of directors, and most of them do so, often giving donors the honorary title of "member." Vacancies on the boards of such corporations are filled by the vote of the remaining directors rather than by members.
Planet Water's members are more than honorary, however, because they have the right to vote for directors. California law gives such members the right not only to vote for directors but also to nominate them. The consent of the membership is required if the board wants to remove a director. Planet Water's members also have the right to receive annual reports on its finances; to inspect and copy its tax returns, minutes, and other records; to vote on the manner in which its assets will be distributed upon dissolution, termination, or merger with another corporation; to receive written notice a reasonable time in advance of any membership meeting; to sue to protect the charity against wrongful acts by its directors; to vote on amendments to the charity's articles of incorporation; and to vote on bylaw amendments that would affect their rights as members.

Despite the presence of these rights, however, voting members of a public benefit corporation are not personally responsible for the charity's debts, liabilities, or other obligations. And members are not personally liable for improper actions of directors, unless the member personally benefits from such an act.

Unlike stockholders of a business, voting members of a public benefit corporation do not own the corporation, nor do they have any right to its assets. Their rights have to do with governance and access to information about the organization. The corporation's assets are held in charitable trust, for the benefit of the public.

Governing Body. Asked to say whether the board or the staff ran Planet Water, an impartial observer would probably say that the staff did. After all, the board meets only four times a year, and then only to set policy, to adopt a budget, and to make grants. But under the law, it is the board who is responsible for the operations of the organization. The organizational role of the staff is to carry out the policies set by the board.

State law defines the responsibilities of Planet Water's directors in broad terms. Like directors of other public benefit corporations in California, they must act in good faith, in the best interest of the charity, with the same degree of thoughtfulness that a reasonable person would apply to the decision-making process. In traditional legal terms, directors owe the corporation a duty of loyalty and a duty of care. If directors adhere to this standard in performing their duties as directors, they will not be penalized personally for acts or omissions that turn out later to have been mistaken.

The distinction between board responsibility and staff management can produce unexpected results. Suppose, for example, that the staff member in charge of payroll fails to pay the employment taxes on time, and the government assesses fines and penalties against Planet Water. The attorney general of California will automatically demand that the individual members of the board of directors, not the employee, personally reimburse Planet Water for the charitable dollars lost to the organization due to the payment of those fines. This is because, under the law, it is the directors, rather than the staff, who are responsible for the acts of the organization. So long as
the directors can demonstrate that they acted responsibly (by, for example, requiring the staff to keep and monitor a calendar of all filing dates), they will probably not be penalized.

The day-to-day decisions about Planet Water's operations are made by its co-executive directors and other senior staff members. They consult with the executive committee on major decisions between board meetings, but the board is generally not involved in these decisions except to ratify actions previously authorized by the executive committee. The board, with fifteen members who are geographically dispersed, is simply too cumbersome a body to respond quickly. State law generally leaves the organization free to decide how many directors it will have (California law requires a minimum of one director). As an organization becomes larger, however, the size of its board of directors tends to follow suit, since the practice is to bring people onto the board who are resourceful and who are in a position to contribute expertise or other resources, including money.

Directors, as we have seen, owe a duty of loyalty to the charity: they must put the best interests of the charitable organization before any personal benefit to themselves. But a charity is not prohibited from dealing with a board member in his or her professional capacity. Planet Water's board, for example, includes its attorney, Susan Cohen; Larry Yee, who owns the public relations agency that produces Planet Water's advocacy advertisements and direct mail appeals; and Jim and Beth Rankin, its founders and co-directors—all of whom are compensated for the professional services they render. Rather than bar a charity from benefiting from the expertise of its board members, California law allows such transactions, so long as the interested director—that is, the director with a financial stake in the transaction—discloses all the material facts to the other directors and they alone decide that the benefit to the corporation outweighs the benefit to the individual director.

At least four of Planet Water's fifteen directors were interested directors. California law permits such interested directors to serve on the board, but only if they make up no more than 49 percent. In practice, the founders of a new organization may have difficulty attracting a sufficient number of outside directors. The hope of the founders is that their cause will have sufficient public appeal that the increase in activities will lead to greater outside recognition and an expansion of the number of resourceful supporters who will be willing to volunteer time to serve as board members and in other capacities.

Some foundations follow a policy of refusing to make grants to organizations that have employees on their boards. The laudable purpose of that policy is to strengthen the independence of the board. The unfortunate consequence, however, is that deserving charities may be disqualified simply because they are at an early stage in their development.

Staff. A charitable organization is not exempt from the extensive body of federal, state, and local labor law regulating employment. Planet Water must
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comply with laws requiring that the amount of wages paid to employees meet a certain minimum standard. It must pay the employees additional compensation if they work more than an eight-hour day or a forty-hour week. California and San Francisco have stronger antidiscrimination laws than the federal government. Those laws, taken together, prohibit Planet Water from discriminating on the basis of race, religion, national origin, sex, sexual preference, physical or mental disability, and age, in the hiring, promotion, or termination of employees.

One type of law applies only to employees of a charitable organization: laws limiting the amount of compensation that an employee may receive. Federal and state laws prohibit the payment of excessive compensation to employees of charitable organizations. The compensation they receive must be reasonable in relation to the services that they perform. There is, by comparison, no such restriction on the amount of compensation that may be received by employees of business organizations.

An individual who wants to engage in a particular activity must take this limitation into account when deciding whether to conduct that activity as a charity or as a business. For example, suppose that a teacher wants to form a school to teach foreign languages, and suppose further that the salary range for language teachers in nonprofit schools in her area is $20,000 to $40,000. If the teacher wants her school to be a charity, she must be content with receiving a salary within that range. On the other hand, she is free to form her school as a business, instead, and to receive as much compensation as her business can generate.

Finances. Except for joint venture income, the sources of financing for Planet Water are fairly representative of a large nonprofit environmental organization. The amount and types of funds received will differ, of course, from organization to organization. A large performing arts organization, such as a symphony orchestra or an opera, would typically receive much of its support from ticket sales, but significant amounts would also come from government and foundation grants, individual and corporate contributions, and investment income. A charitable organization providing a social service, such as housing advice to the poor, would in the past have been supported primarily by government grants. Due to reduced government funding, however, that organization would now be supported, at a reduced level, by foundation and corporate grants and individual contributions.

Most of Planet Water's income is exempt from federal and California income taxes. Even the income that may appear to be commercial in nature— from book sales, government contracts, royalties, and investments— will probably qualify as tax-free to Planet Water. Commercial income that requires no significant activity on the part of the charity to produce it, such as the investment and royalty income, is not subject to the unrelated business tax. The commercial income that does require sustained activity, such as the sale of books or the performance of government contracts, qualifies for that reason as business income. Since the activities of publishing environ-
mental books and conducting environmental research further the purpose of Planet Water, they generate related business income, which is not subject to the tax imposed on unrelated business income.

The joint venture income, from the sale for recreational use of the submersible vehicles, would be taxed as unrelated business income. Income from the sale or rental of such vehicles for environmental research purposes would probably be treated as related income because of its connection to Planet Water's purposes and would, therefore, not be subject to tax.

The direct mail campaign is a form of solicitation for charitable contributions. There is, as yet, no federal regulation of such solicitation. There is an enormous diversity of laws at the state and local level, however. In California alone, more than two hundred cities and counties have enacted laws regulating charitable solicitations. Before Planet Water solicits funds either by mail or door-to-door, it must review the laws of the particular localities and states where it will be soliciting. Those rules commonly require a charity to register with a governmental agency and to disclose its program and its finances. Charities, like businesses and individuals, may not obtain money by fraud or misrepresentation. The government may not regulate charitable solicitation without restriction. Charitable fundraising is an exercise of constitutionally protected free speech, and in recent decisions the Supreme Court has struck down state and local laws regulating charitable solicitation on the ground that they were unduly burdensome of free speech.

The investment of charitable funds is regulated primarily at the state level. Most states require the governing body of the charity to make its assets productive. This means that the surplus funds of the charity must be invested prudently and may not be allowed to lie idle. For example, members of the board of directors of a California charitable foundation were fined by a court because they allowed foundation funds to remain in a non-interest-bearing checking account in excess of the amount needed to meet current expenditures. The court required them to pay to the foundation the amount of interest that the foundation would have received had its excess funds been deposited in a savings account.

State laws do not ordinarily specify which types of investments a charitable organization must choose. California does, however, regulate the process by which the choice is made: it requires the directors to exercise reasonable and prudent judgment. In addition, many states have laws that, like California's, protect the members of boards of directors from liability that might otherwise arise as a consequence of unwise investment decisions, so long as the decisions are made on the basis of advice from a competent professional investment manager.

**Compliance**

Government review of a charitable organization occurs most commonly in connection with the annual reports filed by a charity. Random audits are...
made of those reports. In recent years, sophisticated computer programs have been designed by tax and charitable regulatory agencies. Those programs are applied to the reports to identify legal compliance issues from the information contained in them. An organization may also be selected for audit because of a complaint made by an individual or because a newspaper article describing improper charitable activity comes to the attention of the government agency.

If a charitable organization's report is selected for audit, a government auditor may schedule a visit to the office of the organization. The auditor is empowered to examine any document and to interview any person connected with the charitable organization. Despite this extensive audit power, most charitable organizations have never been audited by any government organization. When they do occur, most audits take no more than a few days, assuming no serious violation of law is uncovered. In most cases, the result of an audit is a "no change" letter, indicating that the organization is in compliance with the laws and regulations of the governmental agency conducting the audit.

Termination

The determination of when a charitable organization should end its existence is ordinarily a private matter, made not by the state, but by the governing body of the organization.

The government has extensive powers in the event of abuse, but the exercise of those powers is surrounded with important protections.

On the federal level, for example, the Internal Revenue Service has the power to in effect terminate the existence of a nonprofit organization by proposing to revoke its tax exemption. Revocation is proper only if specific violations of law have occurred, such as failing to conduct legitimate charitable activities, conducting activities in a manner that confers an improper economic benefit on an individual, or engaging in excessive lobbying or electioneering. In the event of a proposed revocation, the organization has extensive rights to present evidence and to oppose that action within the Internal Revenue Service. If the IRS is unpersuaded, the organization can challenge the proposed IRS action in court.

At the state level, the powers of the tax agency and the protections of the organization are similar. In addition, the state attorney general has extensive powers to investigate the activities of a charitable organization to assure that they comply with the law. The attorney general, however, has no power to act against the organization on his or her own. If that office discovers violations of law and decides to impose penalties over the charity's objections, the attorney general must take the charity to court. The court, not the attorney general, will decide, after a full trial, whether the organization has violated the law; whether a penalty or other remedy should be imposed under the law; and, if so, what the appropriate remedy or penalty
should be. Nevertheless, due to the cost of litigation and the potential of harmful adverse publicity, most disputes between charities and states' attorneys general are resolved by settlement rather than by litigation.

If the organization voluntarily dissolves or terminates and has money or property, those assets must, in California and in most other states, be distributed by the organization to another charitable organization with similar purposes. The attorney general reviews all proposed terminations to assure that charities comply with this rule. For example, if Planet Water's directors voted to end the organization's existence, they could distribute its assets only to other charitable tax-exempt organizations whose purpose was to protect and preserve marine life and the oceans in general. If they wanted to distribute a portion of Planet Water's assets to organizations working on other important social problems, such as homelessness, the attorney general would step in to prevent it. This is because, under the law of charitable trusts, a charity's assets must be used for the purpose stated in its governing document, unless that purpose becomes illegal, impossible, or, in some states, impracticable. Environmental protection, Planet Water's purpose, will, no doubt, remain viable for the foreseeable future.

Reference