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RELINQUISHING TAX EXEMPTION: STATE AND FEDERAL CONSTRAINTS

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During the recent debates over modification of the unrelated business income tax, a number of organizations undertook a review of their status to determine whether an extension of the rules would threaten their tax-exemption unless they abandoned or substantially modified current operations. A possible alternative for an organization adversely affected by the changes would be to relinquish tax exemption. This could be justified on the basis that the now prohibited activities were necessary concomitants of the organization's ability to carry out its charitable purposes and that, if it remained in compliance with the requirements for tax exemption, it could not be true to its mission. This could happen, for example, if the unrelated business income tax was extended to now exempt publishing operations or applied research and this was the sole activity of the exempt organization. Even without tax changes, the possibility of relinquishing tax exemption is raised from time to time, particularly by directors who are accustomed to functioning in a more aggressive taxable world. The subject of this paper is the constraints under federal and state law against relinquishing tax exemption for organizations that intend thereafter to remain charities as that term is defined in state law. I have not addressed directly the voluntary conversions being undertaken by directors of hospitals and HMOs as a way to increase their compensation or to divert to their personal use future (and possibly present) profits. I have also

tried to avoid discussion of the trust law/corporate law dichotomy which pervades the literature and many of the pertinent cases but which, on closer examination, sets up trust law as a straw man to be torn down, often diverting attention from the actual standards that are being applied in the cases.

FEDERAL CONSTRAINTS

I. Relinquishing Exemption.

In its 1985 Exempt Organization Continuing Professional Education Handbook Technical Instruction Program, TPDS 89085, the Internal Revenue Service indicated that, once a determination of exemption had been obtained, it could not voluntarily be relinquished.

Neither the Internal Revenue Code nor the regulations make provision for a voluntary relinquishment of exempt status by organizations that are not private foundations. The language of IRC 501(a) merely states that an organization 'described in subsection (c) . . . shall be exempt from taxation under this subtitle.' The use of the mandatory 'shall' in IRC 501(a) has been construed by chief counsel to mean that so long as an organization does not violate the requirements of exemption, neither the organization nor the Service may disregard such status.

Private Letter Ruling 9141050, issued July 16, 1991, dealt with this question. It was promulgated in response to a request for termination of Section 501(c)(3) status by a school located in Germany. Contributions to the school were not deductible under Section 170; it had no U. S. activities; and it received

no U. S. income. The Service acknowledged that neither the Code nor the Regulations made provisions for voluntary relinquishment of exempt status and pointed to the fact that an organization is given the opportunity to decide whether or not it will file for exemption. "However, once the basic information is conveyed to the Service, the nature of the organization will control in determining whether the organization is exempt". By voluntarily filing to be recognized as an organization described in Section 501(c)(3), the Service considered that the organization surrendered itself to the Rules and Regulations governing tax exempt organizations and a listing in Publication 78.

"Therefore we are unable to terminate your tax status under Section 501(c)(3) without formal dissolution under existing law or without a disqualifying change in your organization or operations."

There appears to be no precedent for this Ruling. Section 507 of the Internal Revenue Code prohibits private foundations from voluntarily terminating their tax-exempt status without (1) paying a tax equal to the lesser of all tax benefits received by the organization since its inception or its net assets; (2) distributing all its assets to a publicly supported charity that has been in existence with that status for at least five years; or (3) itself operating as a publicly supported charity. There is no similar provision applicable to public charities.

The current Assistant Chief Counsel for Exempt Organization Affairs views the existence of this statutory scheme as evidence of the Service's lack of power to prevent voluntary terminations of tax-exempt public charity status. Even if the position taken in the Ruling were correct, it recognizes that an organization can voluntarily achieve loss of exemption by expanding its trade or business activities so that it no longer meets the operational test or by amending its governing documents so that it no longer meets the organizational test, for example, by stating that the primary purpose of the organization is the conduct of a trade or business or, as discussed below, deleting a provision in the corporate charter which the Service considers necessary in order to meet the organizational test. A final alternative would be merger with a new entity that does not seek determination of exemption.

II. Tax Effect of Loss of Exemption.

Revocation of exemption under ordinary circumstances will be retroactive to the date on which the organization ceased to qualify as exempt. The practical effect of this is mitigated, however, by virtue of the provisions of Section 6501(g), under which the filing of a Form 990 in good faith has the effect of letting the statute of limitations run for the year in question, absent fraud or other special circumstances.

Revenue Procedure 86-1, 1986 C.B.1, 395, contains the general rule that revocation will be effective as the date of a

change in law if an existing organization does not modify its activities to conform to the change and thereby forfeits exemption. It is interesting to note that, contrary to the 1985 statement regarding relinquishment, this ruling presupposes a voluntary decision not to comply with the new law.

In 1989, after the revocation of exemption of the Synanon Church, TCM Memo 1989-270, the Office of Chief Counsel of the Internal Revenue Service published GCM 39813 (March 20, 1990). This memorandum examined the tax treatment of public charities whose tax exemption had been retroactively revoked and of individuals connected with such organizations. The memorandum stated that regardless of the tax treatment of contributions at the organizational level, payments by an organization to or for the benefit of a principal are deductible by the organization and taxable to that principal. With respect to tax treatment at the organizational level, the memorandum stated that organizations whose tax exemptions had been retroactively revoked would be taxed on net income from all business and investment activities. With respect to contributions given in good faith, they would be excluded from income under Section 102 only if the organization acted in good faith in soliciting them, believed it was tax-exempt at the time of solicitation and intended to use the contributions for exempt purposes. The memorandum stated that, while a finding of misrepresentation would not automatically follow from the fact of revocation of

exemption, misrepresentation would be presumed to exist where an organization which received contributions was found to have engaged in a pattern of activities inconsistent with its tax exemption. If contributions were included as income to the organization due to failure to meet the above requirements, expenditures within the same tax year for exempt activities conducted by the organization, along with an allocable portion of fundraising costs and contributions to other Section 501(c)(3) organizations, would be deductible from income attributable to contributions, but excess losses could not be used to shelter other income. The result would be a tax on contributions to the extent that they were used for the benefit of private individuals or for other nonexempt purposes.

Because it lacks the power to impose excise taxes on public charities similar to those applicable in cases of self-dealing by private foundations, the Service is forced to rely on its ability to revoke exemptions retroactively, a limited power at best. One of the more recent applications of this power can be seen in Private Letter Ruling 9130002 issued in June of 1991, where the Service revoked the exemption of a non profit hospital corporation as of the date of sale of its hospital facility to a for profit corporation controlled by its directors for less than market value, thereby violating the prohibition against private inurement. The hospital and its directors were also the subject of legal action by the Attorney General of Florida in 1987, in a

case which resulted a finding that the directors had violated their fiduciary duty, but not the dissolution of the corporation or entry of an order for restitution. Butterworth v. Anclote Manor Hospital, 566 So. 2d 296 (Fla. App. 1991).

The timing of the effective date for loss of tax-exempt status is also important from the point of view of contributors. Revenue Procedure 82-39, 1982C.B.1, 759, sets forth the rules under which donors may rely on the list of exempt organizations published from time to time by the Service as Publication 78. In general a donor may rely on a listing in the Publication until the date of publication, usually in the Internal Revenue Bulletin of notice that the status of an organization has been changed. However, a donor may not rely on the public notice rules if he knew of the existence of the ruling or determination letter revoking exemption, was aware that revocation was imminent, or was personally responsible for or aware of the activities or deficiencies on the part of the organization which led to revocation.

It should also be noted that under Section 6104(c), the Internal Revenue Service is required to notify appropriate state officers when it makes a determination that an organization no longer qualifies for exemption under Section 501(c)(3). It is not clear whether this provision would apply in the case of an organization which notified the Service voluntarily that it was relinquishing tax-exempt status or which, as of a certain date, filed as a taxable organization and stopped filing as tax-exempt.

In summary, the federal law is unclear as to whether and under what circumstances an organization can voluntarily relinquish its tax exemption, although there appear to be ample opportunities to do so. The major sanction which the Service has to prevent this, however, is the essentially ineffective tool of retroactive taxation. This, of course, has the ironic effect, well recognized, of diminishing funds otherwise available to serve the public. It imposes no constraint on the actions of the directors.

STATE CONSTRAINTS

I. State Law Standards Governing the Actions of Officers and Directors.

The fiduciary duties of officers and directors of charitable corporations are often categorized as consisting of a duty of care, a duty of obedience to the corporation's purposes, and a duty of loyalty. It is the first two of these duties that would be examined to determine whether the conduct of the officers and directors of an organization voluntarily relinquishing tax exemption would constitute a breach of their fiduciary duties.

A. The Duty of Care and the Business Judgment Rule.

The American Law Institute, through its Corporate Governance Project, is in the process of revising its restatement of the duty of care of the directors and officers of business corporations. The most recent draft of this provision,

which was tentatively approved at its May 1991 meeting, reads as follows:

(a) a director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances. This Subsection (a) is subject to the provisions of Subsection (c) (the business judgment rule) where applicable...

(c) A director or officer who makes a business judgment in good faith fulfills his duty under this Section if: (1) he is not interested...in the subject of his business judgment, [e.g. he has not breached the duty of loyalty described below] (2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and (3) he rationally believes that his business judgment is in the best interests of the corporation.

American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, Tentative Draft No. 11, 177-78 (1991).

The Corporate Governance Project commentary states that this formulation of the duty of care is consistent with articulations of the duty of care in current statutes and judicial decisions. Id. at 171. Although it has been framed for business corporations rather than nonprofit corporations, in a 1974 case decided by the United States District Court for the District of Columbia, Stern v. Lucy Webb Hayes National Training School For Deaconesses and Missionaries, 381 F. Supp. 1003 (D.D.C. 1974), commonly referred to as the "Sibley Hospital"

case, the court held that the standard of care applicable to business corporations was applicable to nonprofit corporations organized under the laws of the District of Columbia. The Sibley Hospital case has been discussed in the literature principally because it is among the most recent of the mere handful of cases to address this issue.

At issue in the Sibley Hospital case was a charge that the Hospital's directors had breached their fiduciary duties of care and loyalty by failing to supervise the hospital's investments, thus permitting negligent mismanagement by others to go unchecked, and by engaging in self-dealing. Stern, 381 F.Supp at 1013-16. After holding that corporate principles should be applied, the court formulated a duty of care that requires directors to exercise "ordinary and reasonable care in the performance of their duties, exhibiting honesty and good faith." Stern, 381 F. Supp. at 1015. The court held that a director of a charitable corporation has breached his duty of care if he has "failed to perform his duties honestly, in good faith, and with a reasonable amount of diligence and care." Stern, 381 F. Supp. at 1015. Emphasizing factors such as the directors' failure to object when no meetings of the investment committee were held for more than ten years, the court held that the directors had breached their duty of care by failing to exercise even the most cursory supervision of the handling of hospital funds.

There has been considerable debate regarding whether it is appropriate to apply the business judgment rule to the decisions of officers and directors of charitable corporations whose ultimate goal is to further the charitable purposes of those corporations rather than to maximize profits. See, e.g., D. Kurtz, Board Liability: Guide for Nonprofit Directors 49 (1988); E. Hadden and B. French Nonprofit Organizations' Rights and Liabilities For Members, Directors and Officers 72 (1987). The Sibley Hospital case did not explicitly discuss the business judgment rule. However, it relied heavily on Beard v. Achenbach Memorial Hospital, 170 F. 2d 859 (10th Cir. 1948), in which the court did apply the business judgment rule to the directors of a charitable corporation, holding that "ill-success or bad judgment not so reckless or extravagant as to amount to bad faith or gross or wilful negligence on the part of the directors...[does] not warrant...the rendition of a personal judgment against the directors." Beard, 170 F. 2d at 862. In addition, the rationale given by the court for applying the corporate standard to directors of charitable corporations in the Sibley Hospital case - that their functions are "virtually indistinguishable from those of their 'pure' corporate counterparts"- gave that court a basis for applying the business judgment rule. See Troyer, Slocombe and Boisture, Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions and Pension Funds, 74 Geo. L. Rev. 127, 136 (1985).

In discussing the duty of care, the Corporate Governance Project commentary states that the phrase "best interests of the corporation" indicates that the director's allegiance must be to the corporation rather than to his own interests, id. at 190 (citing the Corporate Director's Guidebook p. 1601), that the phrase "ordinarily prudent person" is intended to convey the image of a generalist with no special expertise, id. at 190, that the phrase "in a like position" is intended to recognize, among other things, that special skills or expertise of a director may place greater responsibility on him, and that the phrase "under similar circumstances" recognizes that the obligations of a director or officer will vary depending upon factors such as the nature of the business, the urgency and magnitude of the problem and the corporation's size and complexity. Id. at 195 (emphasis added).

The commentary states that the business judgment rule, which has been developed by the courts in a number of jurisdictions but not yet embodied in statutes, is intended to protect directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions and to avoid the risk of stifling innovation and venturesome business activity. Id., at 180, 223. Other commentators have expressed the rule as a presumption that in making business decisions officers and directors have acted on an informed basis, in good faith and with an honest belief that their actions are in the

best interests of the corporation, see, R. Belotti and J. Finkelstein, The Delaware Law of Corporations and Business Organizations 4-40 (2d. Ed. 1990). They have also stated that where courts find that the business judgment rule applies, they will generally not question the business decisions of disinterested directors if they can be attributed to any rational business purpose. Id. at 4-41. The commentary to the Corporate Governance Project formulation of the business judgment rule indicates that the factual context in which a business judgment was made (including, for example, the importance of the business judgment to be made, the time available for obtaining information, the cost of obtaining information, the nature of competing demands for the board's attention, and the state of the corporation's business) must be taken into account in determining when a director acted "reasonably" in determining that the information he possessed was "appropriate under the circumstances," id. at 231-32, and that the use of the word "rationally" rather than "reasonably" in the formulation is intended to provide directors and officers with a wide ambit of discretion, id. at 181, consistent with the majority of business judgment cases. Id. at 234.

A somewhat different formulation of the duty of care is used in the the Revised Model Nonprofit Corporation Act (the "Revised Model Act"), which was drafted by the Committee of Nonprofit Corporations of the Section of Corporation, Banking

and Business Law of the American Bar Association as an attempt to offer direction for state legislators drafting statutes dealing with nonprofit corporations. It sets forth a similar formulation of the "reasonable care" standard, stating that directors shall discharge their duties "in good faith . . . with the care an ordinarily prudent person in a like position would exercise under similar circumstances . . . and in a manner that the director reasonably believes to be in the best interests of the corporation". Revised Model Act §8.30.

The Revised Model Act does not attempt to develop a statutory formulation for the business judgment rule. However, the official comments state that the application of the business judgment rule to directors of charitable corporations, while not firmly established by the case law, is consistent with the standard of care set forth in the Revised Model Act and that the business judgement rule should be applied to all discretionary matters voted on by the directors of charitable corporations (e.g., decisions relating to funding a project, determining what play to produce or what animals to have in the zoo) rather than just those that can be categorized as "business" decisions. Revised Model Act, Official Comments to §8.30.

In those states where the duty of care for the officers and directors of charitable corporations is similar to the duty of care for officers and directors of business corporations, a higher standard may nonetheless be applied in the case of

charitable corporations. This was the intent of the drafters of a new statutory standard of care enacted in 1989 in Massachusetts. It requires that a director or officer perform his duties "in good faith and in a manner he reasonably believes to be in the best interests of the corporation and with such care as an ordinarily prudent person in like position with respect to a similar corporation organized under this chapter would use under similar circumstances." M.G.L. c. 180 §6(c). The underscored language, which does not appear in the statutory duty of care for the officers and directors of business corporations, was adopted to emphasize that the charitable purposes of the corporation and its perpetual existence were to be considered.

In the Sibley Hospital case, the court did not discuss the charitable purposes and perpetual nature of charitable corporations directly in determining whether the directors of the hospital had met their duty of care. Nonetheless, it would be foolish for the officers and directors of a charitable corporation to assume that its charitable and educational mission would not be a factor to be considered by a court in determining whether they had met their duty of care.

B. The Duty of Obedience to Purpose.

In addition to the duty of care, the officers and directors of a charitable corporation have a duty to act in obedience with the corporation's charitable purposes. This entails a mandate

to carry out the purposes of the corporation as expressed in the legal documents creating and defining its mission, generally its charter and by-laws. See, e.g., D. Kurtz, Board Liability: Guide for Nonprofit Directors 85 (1988). Oberly v. Kirby, Fed. Sec. L. Rep., ¶95,852, Del. 1991). Similarly, in the trust context, the trustee has an overriding duty to carry out the terms of the trust. G. Bogert, Trusts and Trustees §541 (2d ed. 1977). A gift to a charitable corporation, if not restricted to use, is deemed to incorporate the purposes set forth in the charter or other governing instrument of the donee corporation. G. Bogert, Trusts and Trustees §362 (2d ed. 1977).

Some courts have held that a charitable corporation's purposes may be limited beyond those set forth in its governing instrument by the actions of the corporation or by representations made in public documents describing the corporation's purposes (e.g., applications for recognition of tax exemption, public solicitations and grant proposals). For example, in Queen of Angels Hospital v. Younger, 136 Cal. Rptr. 36, 40 (1977), a California court held that a hospital's charitable purposes had been narrowed beyond what had been set forth in its articles due to the actions of the hospital and public representations, including statements made to tax authorities and statements made in fund solicitations. Similarly, a New York court, applying the New York not-for-profit corporation statute, held that in determining

whether to approve a plan for distribution of a charitable corporation's assets upon dissolution a court must consider the activities carried out by the corporation if those activities are more limited than those allowed by the charter and must consider any restrictive statements made during public solicitations of funds. In the matter of Multiple Sclerosis Service Organization of New York, Inc., 496 N.E. 2d 861 (N.Y. App. 1986).

A Massachusetts court has held that if a charitable corporation validly amends its charter to change its purposes, funds which represent gifts received prior to the amendment may not be used to carry out the new purposes. Attorney General v. Hahnemann Hospital, 397 Mass. 820 (1986). In this case the Attorney General challenged the action of a charitable hospital corporation which amended its charter to authorize the sale of all of its assets to a for-profit corporation, after which it intended to operate as a grant-making foundation using the income from the proceeds of the sale. The court held that the directors were authorized by statute to sell all of the assets of the corporation and that they had not violated their fiduciary duties by amending the charter to authorize the sale. However, to the extent that the amended purposes of the corporation were broader than the purposes authorized in the trust pursuant to which the corporation was established, the directors would violate their fiduciary duties if they applied

to new purposes any proceeds of the sale attributable to donations from the trust and any funds attributable to donations made prior to the date of the amendment of the charter.

Hahnemann Hospital, 397 Mass. at 834-36 (emphasis added).

Thus the Queen of Angels case and the Hahnemann Hospital case both hold that if the purposes of a charitable corporation are changed from those purposes articulated in the original charter -- either because they have been narrowed by subsequent representations and activities, as in the Queen of Angels case, or because they have been broadened by subsequent amendment to the charter, as in the Hahnemann Hospital case -- funds donated prior to the change in purposes cannot be applied to carry out the new purposes. See Hansmann, *Reforming Non Profit Corporation Law*, 129 U. Penn. L. Rev. 497, 575-6 (1981).

Under the nonprofit corporation acts of some states, incorporation is permitted only for purposes that fit within a specific category or listing so that a change of purpose is possible only if the new purposes are within the statutory category. As a practical matter, however, this is not a serious problem for most non-profit corporations because the categories "charitable" and "educational" appear in the non-profit corporation statutes in all jurisdictions. In states such as California where the nonprofit corporation statute divides corporations into two separate categories, mutual benefit and public benefit corporations, it is not possible for a public

benefit corporation which has any assets to change to a mutual benefit corporation or to merge with any type of corporation other than another public benefit corporation unless the change has been approved in advance by the Attorney General. The Revised Model Non-Profit Corporation Act, which attempts to bring statutory law into conformity with the principles of the law of charities (charitable trust law) while preserving for the officers and directors of charitable corporations some freedom of action similar to that given to directors of business corporations, requires court approval of mergers of public benefit corporations with business corporations unless prior to the merger assets with a value equal to or greater than the fair market value of the net tangible and intangible assets of the merging public benefit corporation have been conveyed to another public benefit corporation which could have received the assets of the merging public benefit corporation had it dissolved. More stringent statutory standards in jurisdictions such as Massachusetts in effect prohibit both mergers of nonprofit corporations with charitable purposes into business corporations and mergers of Massachusetts nonprofit corporations with nonprofit corporations organized in other jurisdictions unless the surviving corporation agrees that it may be sued in Massachusetts for certain prior obligations of the constituent corporations.

C. The Duty of Loyalty.

The duty of loyalty is commonly understood to require that officers and directors act in good faith and in a manner which they reasonably believe to be in the best interests of the corporation. The duty of loyalty thus includes prohibitions against usurping corporate opportunities, abusing the public interests of a charitable corporation for private profit, using inside information for individual gain, and other forms of self-dealing. The officers and directors of a charitable corporation, like the trustees of a charitable trust, have a duty to act to accomplish the purposes of the corporation, not to further their own interests. See Scott on Trusts, §379 (4th ed. 1988). The Sibley Hospital case in large part dealt with the directors' breach of this duty of loyalty; with the court finding that all of the directors had "at one time or another, affirmatively approved self-dealing transactions." Stern, 381 F. Supp. at 1016.

The most recent discussion of self-dealing by directors of charitable corporations appears in the 1991 case of Oberly v. Kirby, Fed. Sec. L. Law Rep., ¶95,852 where the Supreme Court of Delaware explicitly applying corporate law principles to a situation where all of the directors were interested in a transaction, held that a judicial determination of the transactions fairness, in which the directors held the burden of proof, was necessary.

II. Remedies for Breach of Duties and Standing to Enforce.

A. Remedies.

There are very few cases holding officers or directors of charitable corporations individually liable for breach of their fiduciary duties. In most of these cases self-dealing and other breaches of the duty of loyalty were involved. See Harvey, The Public-Spirited Defendant and Others: Liability of Officers and Directors of Not-for-Profit Corporations, 17 J. Marshall L. Rev. 665, 699 (1984). However, if liability is found, courts uniformly apply equitable rather than legal remedies. See Scott on Trusts §392 (4th ed. 1988); G. Bogert, Trusts and Trustees, §411 (2d ed. 1977). In the Sibley Hospital case the court described the broad range of its equity powers, which include ordering an accounting, surcharging an officer or director for financial harm to the corporation occurring as a result of his breach of fiduciary duty, ordering the removal of an officer or director, or ordering declaratory or injunctive relief. Stern, 381 F. Supp. at 1020-21. It should be noted that in the Sibley Hospital case, despite the court's determination that the directors had breached their duties of care and loyalty, it refused to order the relief requested by the plaintiffs. Specifically, the court declined to order removal of the directors from the Board, to order an accounting, or to order that damages be assessed against the directors (e.g., to order that the directors be surcharged). Instead, the court limited

its relief to a declaration defining what it considered the duties and obligations of directors of nonprofit hospitals and an injunction requiring that the appropriate committees and officers of the hospital present to the full board a written investment policy and establish a procedure for periodic re-examination of existing investments and financial arrangements, that each newly elected director read the court's opinion and order, and that the board make certain public disclosures with respect to business done by the hospital with financial institutions with which any of the directors or officers were affiliated. Stern, 381 F. Supp. at 1020-21.

Although courts may be reluctant to order more extreme remedies such as the removal of officers and directors, the adverse publicity that would accompany a public finding that there had been a breach of fiduciary duties to a charitable corporation would be harmful to the reputation of its officers or directors even if they were not removed or surcharged. For a charitable corporation which relies heavily on support from the public, such a finding would also be injurious to the corporation's image with a result of diminished public financial support.

B. Standing.

Although officers and directors may be held personally liable for breach of their duties to charitable corporations, very few persons have the power to sue them for breach of these

duties. The attorney general in all but two states has virtually exclusive standing to bring an action to prevent diversion of property from the purposes for which it was given. This right stems from the common law power given to the attorney general as parens patriae to enforce the proper administration of charitable funds. See Scott on Trusts §348-1 (4th ed. 1988). In some cases this power is conferred on other officials, either acting along with the Attorney General or exclusively. For example, in the District of Columbia the Court of Appeals recently stated that although, unlike many jurisdictions, the District of Columbia does not have a statute specifically authorizing any public officer to bring actions to enforce the proper use of charitable funds, courts in the District of Columbia recognize the power of a public officer such as the Corporation Counsel to sue in a parens patriae capacity to enforce the public right to continuing application of charitable property to proper purposes. Hooker v. Edes Home, 579 A.2d, 608 (D.C. App. 1990) 610-12 and n.9.

In many states, the only persons other than the attorney general or an analogous public official who may bring actions to enforce officers' and directors' duties are other directors and the members of the corporation. What is meant by members in this context, however, is those persons with the power to elect directors of the corporation, e.g., those who stand in a position analogous to that of the stockholders of a business

corporation. Other persons may be referred to by a charitable corporation as "members," such as the members of a museum, but they generally do not have the right to sue to challenge the actions of the officers and directors. See Karst, The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility, 73 Harv. L. Rev. 444 (1960).

In contrast to the general rule in most jurisdictions which denies standing to persons other than the attorney general, directors and members, in the Sibley Hospital case patients of the hospital who alleged that they had suffered harm of a different nature than the harm suffered by the general public because they had been forced to pay higher prices for hospital care were allowed to sue the directors for breach of their fiduciary duties. See Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries, 367 F. Supp. 536 (D.D.C. 1973). Similarly, in Hooker, potential residents of the Edes Home were allowed to challenge the actions of the directors. Hooker, 579 A.2d 608.

In states where the attorney general exercises active supervision over charitable corporations, courts appear less inclined to permit individuals to sue than in jurisdictions, such as the District of Columbia, where the attorney general does not play an active role. For example, the Massachusetts Supreme Judicial Court held in Ames v. Attorney General, 332 Mass 246 (1955) that individuals who had contributed to an

arboretum maintained by Harvard College but who had no interest in the arboretum other than that of the general public lacked standing to challenge the actions of the directors of the College with respect to the arboretum or to force the attorney general to reconsider his decision not to file suit against the directors, emphasizing the active role taken by the attorney general in enforcing the proper application of charitable funds.

Kurtz has suggested that in most of the cases in which courts have departed from the traditional narrow view of who has standing to bring suit to enforce directors' duties, such as the Sibley Hospital case, the facts were so strongly indicative of wrongful action on the part of the directors that the courts strained to give the plaintiffs standing. D. Kurtz, Board Liability: Guide for Nonprofit Directors 93 (1988).

Recent developments in California demonstrate the difficulty that can arise when the power of the Attorney General to regulate charities is curtailed. In 1983 the statutes governing nonprofit hospitals and health service plans were amended to substitute the Insurance Commissioner for the Attorney General in the case of hospital service plans and, for health service plans, the Commissioner of Corporations. After the Commissioner of Corporations approved the conversion of an HMO to for-profit status in a transaction where the market value was alleged to be grossly understated, suit was brought to rescind the conversion. The California Supreme Court held that

a 1983 amendment gave exclusive jurisdiction to the Department of Corporations to approve such actions, thereby preempting the Attorney General's supervisory power, Van de Camp v. Gumbiner, 221 Cal. App. 3d. 1260 (1990). Since that time two other attempted conversions have received a great deal of publicity, most recently in July the conversion of Healthnet, the state's second largest HMO. An Assistant Attorney General in the Los Angeles office described the current HMO conversion situation as the "miracle of the loaves and fishes". According to press reports, a new Commissioner of Corporations indicated that he intends to monitor the conversions more closely, but it is apparent that his powers are far more limited than the common law powers of the Attorney General.

III. Liability for Loss of Tax Exempt Status.

There do not appear to be any cases holding the officers or directors of a charitable corporation individually liable for loss of a corporation's tax exempt status. However, under the general principles reviewed above, a court asked to determine whether actions which resulted in a corporation's losing its tax exempt status were violations of fiduciary duty. Analysis of the losses that would follow such actions, balanced against the perceived advantages, but measured in terms not of actual outcome but the reasonableness of the decisions. Included in the analysis would be a review of the degree of harm that would follow loss of tax exempt status, not just on the federal level,

but also in regard to the benefits conferred at the state and local levels through exemption from income, sales and real property taxes, as well as eligibility for receiving gifts deductible in determining state and local taxes.

In some jurisdictions exemption from income and sales taxes is automatically extended to all organizations holding determination of tax exemption under federal law. In others, exemption may be granted to the same categories of organizations, but with the state reserving to its officials the actual determination. Exemption from local real property taxes is rarely conferred automatically to organizations with federal exemptions and the standards vary widely. Thus, although loss of federal tax exemption may not lead automatically to taxation at the state and local level, it would likely follow, particularly if the change in status were brought to the attention of local authorities either by the Internal Revenue Service or because of adverse publicity.

IV. Effect of Restrictions Regarding Tax Exemption in an Organization's Charter.

The organizational test, as set forth in the Treasury Regulation 1.501(a)(3) - 1(b)(1)(6) requires that the articles of organization limit the purposes of the corporation to one or more exempt purposes and not expressly empower it to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or

more exempt purposes. Publication 557, Tax Exempt Status for Your Organization, contains a sample form of articles of organization which, as a practical matter, has the force of Regulation in that an organization seeking exemption will not be successful if it has not included the specified provisions. One of the provisions in this sample form states: "Notwithstanding any other provision of these Articles, the corporation shall not carry on any other activities not permitted to be carried on (a) by a corporation exempt from federal income tax under §501(c)(3) of the Internal Revenue Code . . . or (b) by a corporation contributions to which are deductible under Section 170(c)(2) of the Internal Revenue Code. . ." If this language remained in its charter, officers and directors of a tax exempt organization would violate their duty of obedience to its purposes if they authorized any actions which they did not believe in good faith to be consistent with tax exempt status. However, if the organization amended its charter to remove such a provision, this action would have to be reported to the Internal Revenue Service, thereby giving it grounds to seek revocation of tax exempt status for failure to meet the organizational test or because the amendment was evidence that the organization no longer intended to meet the operational test.

CONCLUSION

There are virtually no constraints under federal law that would prohibit directors of a charitable corporation from voluntarily relinquishing tax exemption and, without major revision of the Internal Revenue Code, their freedom to so act will continue. At the state level, the constraints are not substantial so long as the charitable organization's fiduciaries can demonstrate that they made a good faith determination that loss of exemption was in the best interests of the organization. In making that determination, they would have to consider both financial and non-financial factors, including federal tax consequences, the effect of loss of preferential postal rates, state and local tax consequences, possible discouragement of donations through adverse publicity, loss of tax deductions currently available to donors, and eligibility to receive funds from certain foundations and government agencies, the ability to issue tax-exempt bonds, exclusion from membership in those organizations which require participants to be tax exempt, and the potential impact upon the organizations image and reputation and, therefore, its continued ability to carry out its charitable mission. Ultimately, however, it is more likely that financial considerations will be determinative.

Given the present state of the law, directors of charitable organizations can be advised that they would not be in jeopardy

for engaging in activities which entailed reasonable business risks. There is no authority, however, which would permit them to rely on the business judgment rule for protection should they authorize actions which might be justified if they were operating a speculative business enterprise. The safest course for charitable fiduciaries, therefore, is to review their decisions in the light of the charitable nature of the organization and the fact that considering their duties are owed to the general public and not to private shareholders. As to the likelihood of suit being brought to prevent loss of exemption, in those states where there is little or no regulation of charities, the acts of fiduciaries will rarely be questioned. In the other states, which are the most heavily populated ones, a well considered plan involving relinquishment of exemption would likely withstand attack by the attorney general or other state officer. Furthermore, it is only in a few jurisdictions that members of the public are given standing to bring suit and in most cases the requisite interest in the charity would be difficult to establish.

As present law stands, loss of tax exemption is an attractive alternative for only a few charities. However, if Congress were to extend the unrelated business income tax provisions or curtail deductibility of contributions, or if the Service were successful in expanding the "commensurate activity" test or expanded its regulation of solicitation of charitable

funds, relinquishing tax exemption could be an attractive option, not only for organizations that do not rely on contributions for support, but also for those that look for their support to those members of the general public who do not itemize deductions. For some of these organizations, tax exemption may appear to be of less value than increased federal regulation.

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