

Tax Rules for Not-for-Profit Organizations
A Survey of Practice

by

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Introduction. The basic thesis of this paper is that modern governments should establish a set of liberal tax benefits for not-for-profit organizations (NPOs) and the people who support them. It describes the tax rules that are applied to NPOs and their donors in various countries around the world. It is based on primary research and a variety of secondary sources. The purpose of the paper is to provide a broad and detailed understanding of many aspects of the fiscal regimes affecting NPOs on a global basis. Although it is clear that not all NPOs provide social goods and meet social and economic needs, the paper assumes that the unworthy ones will be weeded out so that the indirect state support provided through tax exemptions and tax benefits for donations reaches only those organizations that play a positive role, in other words, those organizations that contribute to civil society.

The thesis of the paper has strong historical support, for almost as early as there is recorded history of taxes being levied, there is also recorded history of tax exemptions being granted. In ancient Egypt, for example, the issue of tax exemptions for temples and priests was raised as early as 2400 BC.¹ And in ancient Greece and Rome the same types of exemptions were also present. By CE 313 tax exemptions were already available for Christian churches. Thus it is clear that states from the earliest times recognized the importance of allowing tax benefits for the parts of society that provided services of certain types.

¹ See Dues and Duties in Ancient Egypt, available at <http://nefertiti.iwebland.com/index.html>.

There is, however, something of a conundrum when we think about the role that taxation plays in the lives of modern citizens. One of the most important Supreme Court justices in American legal history, Oliver Wendell Holmes, Jr., once wrote in a judicial opinion “Taxes are what we pay for a civilized society.” This famous quote is now inscribed on the building that houses the Internal Revenue Service in Washington, DC, and it has come to be accepted by most US citizens as stating an underlying principle of the American society. In fact, it describes a notion that underlies all systems of taxation in the world – if we did not pay taxes there could be no government services for people to consume. Lacking such services we would not be a “civilized” society in the sense in which that term is understood in modern liberal democracies.

A strong and robust civil society is at the current time accepted as an important part of a civilized society – civil society is generally seen as a prerequisite for the existence of a modern liberal democracy.² According to Francis Fukuyama, “If a democracy is in fact liberal, it maintains a protected sphere of individual liberty where the state is constrained from interfering. If such a political system is not to degenerate into anarchy, the society that subsists in that protected sphere must be capable of organizing itself. Civil society serves to balance the power of the state and to protect individuals from the state's power.”³

If the Holmes notion is correct (i.e., that taxes are what we pay for a civilized society), why should there be tax benefits for not-for-profit associations and foundations – the ones that occupy Fukuyama’s “protected sphere?” In order to justify such tax benefits we must recognize that we expect such organizations to provide benefits to the society in such manner and to such an extent that they make up for the tax benefits they receive. This is equally true for ordinary not-for-profit associations, which benefit the society by promoting pluralism, and for the organizations that provide charity services and make a direct contribution to society in that fashion. Thus, all NPOs that fit within the civil society⁴ should be entitled to tax benefits as long as they meet the criteria discussed in Part I.

I. What are the NPOs and PBOs that are entitled to tax benefits?

² Ernest Gellner, *Conditions of Liberty: Civil Society and Its Rivals* (London: Hamish Hamilton, 1994.)

³ Francis Fukuyama, *Social Capital and Civil Society*, a paper presented at the IMF in 1999 and available at <http://www.imf.org/external/pubs/ft/seminar/1999/reforms/fukuyama.htm>.

⁴ It is arguable that some kinds of organizations do not fit within the definition of “civil” society, e.g., skinheads and the Ku Klux Klan.

The general understanding in legal systems around the world is that an NPO is (1) a legal person (2) that is not principally organized or operated to make and distribute profits, (3) that is not part of the State, and (4) from which no profits, earnings, or assets can be distributed other than for its not-for-profit purposes. For purposes of this paper, the crucial category of NPOs is that of “public benefit organizations” (PBOs). In general understanding, a PBO is (1) an NPO that (2) has the exclusive purpose of acting for the public good by benefiting (a) all members of the community or (b) some particular group that is disadvantaged or otherwise deserving of special benefits. Thus, an NPO formed to improve the environment or to protect orphans would be a PBO under virtually every legal system in the world.

II. Income or Profits Tax⁵ Rules.

1. Income or Profits Tax Exemption in General⁶

The definition of NPO being used here assumes that an NPO is precluded from providing personal benefits to founders, donors, members, employees, and so forth, or distributing profits to such persons or to anyone else except pursuant to its not-for-profit purposes.⁷ Thus, there is a powerful argument that these organizations are not proper objects of an income tax in any system. Income taxes are imposed on the “profits” of legal entities because they are surrogates for the individuals who own them or who can receive a distribution of profits from them.

NPOs, as defined here, stand on an entirely different footing from business corporations. They are not “owned” by anyone and cannot distribute profits as such. Whatever profits they may earn from their economic and investment activities must be reinvested or spent on appropriate purpose-related activities (i.e., activities related to their not-for-profit purposes). NPOs are not surrogates for shareholders who own them,

⁵ Some countries have one tax law governing the taxation of the *income* of physical persons and another tax law governing the taxation of the *profits* of legal persons. In most countries these income and profits taxes are included in one law, often called the income tax law.

⁶ Although NPOs are referred to as *being* exempt from taxes throughout this paper, it is important to note that such exemption is not a matter of course – NPOs must apply to be tax exempt. The process of applying for tax exemption may be lengthy, and it may well be that different applications are required for different taxes (e.g., for income or profits tax, on the one hand, and VAT, on the other). Criteria for exemption may differ as well.

⁷ One important issue in China at present is the extent to which private persons may “invest” in an organization set up as a *minban fei qiye danwei*. In the view of the authors, such an “investment” would violate the principle that profits cannot be distributed and would make these organizations similar enough to for-profit business organizations that they should be characterized as such.

and thus it can be strongly argued that they should not be subject to income taxation at all.⁸ Unfortunately, most countries around the world assume that NPOs, like for-profit entities, are potential subjects of taxation, and that not applying tax to them is a matter of grace and exemption.⁹ Nevertheless, most countries do grant broad tax exemptions and other tax benefits to NPOs, especially PBOs.

Apart from receipts from economic or business activities, which are considered below in Section 3, typical sources of revenue for NPOs include donations, grants, subsidies, membership dues, interest and dividends on investments, and gains from sales of assets. The first two groups of revenue sources – donations (gifts, grants, subsidies, etc.) and membership dues – are generally not be taxed to NPOs in countries in the world because the tax laws do not ordinarily include such items in the definition of income.¹⁰ For example, Section 102 of the Internal Revenue Code of the United States excludes gifts from income with respect to all taxpayers. The theory is that the donor has already been taxed on the item and to include it in the income of the donee would subject it to double taxation. Prominent scholars in the United States believe that this

⁸ The situation in Sri Lanka illustrates that there may be positions between treating NPOs as full taxpayers and exempting them on all their income. In that country the corporate income tax is levied on charities at a concessional rate of 10 percent on income in excess of Rs. 42,000 per annum, and the tax can be waived for charities providing institutional care. The theory behind this rule apparently is that better accountability will be assured if sizable charities are required to file tax returns, even though the tax rate is quite low. See ESCAP, *FISCAL INCENTIVES FOR NONGOVERNMENTAL ORGANIZATIONS IN ASIA-PACIFIC* (1994) (hereinafter *FISCAL INCENTIVES*).

⁹ A typical example of how difficult it is for NPOs to obtain tax exemption in some countries is provided by Thailand: in that country an NPO registered as a foundation or an association may seek tax exemption if its purpose is charitable, which means that it is related to religion, education, health, or social welfare. No NPO can qualify for tax exemption until it has operated for three years, although this rule may be waived by the Ministry of Finance. During the prior three years, the NPO must have spent 60% of its income or 75% of its total expenditures on charitable purposes. The result of these rules is that only about 200 NPOs have tax exempt status in Thailand. See ESCAP, *FISCAL INCENTIVES*, *supra* note 4.

¹⁰ Like other gifts, grants, donations, and subsidies received by religious, charitable, or educational institutions are ordinarily not treated as being subject to tax. Some grants may look like contracts or even be in the form of a contract, but the proceeds of such a “contract” will generally not be taxed so long as the NPO is receiving funds to provide goods or services to third parties. If the contract is one to render goods or services to the contractor, however, the proceeds of that contract may properly be treated as income from an economic activity.

Membership dues are not taxed in large part because they are expended in connection with the performance of services for members. If the dues were included in income when received and the costs of member services were deducted when paid, the probable increase in tax revenues would be minor and the costs of collecting taxes would undoubtedly outweigh the gains. It therefore makes good sense not to tax revenues from membership dues. Those who pay membership dues will generally not be allowed to deduct them for income tax purposes, nor will they generally be treated as receiving income as a result of receiving the benefits of membership.

exclusion warrants non-inclusion of such items in the income of NPOs.¹¹ It is clear, of course, that if the donation to a PBO is also given a tax preference there is a double tax benefit – exclusion for the donee and a deduction or credit for the donor. But since the tax preference does not equal 100% of the donation¹² granting both tax benefits is usually seen as an appropriate subsidy for the PBO sector.

An exception to the general rule can be found in Tanzania, where recently enacted legislation includes grants, donations, and other receipts in the income of PBOs, but permits a PBO (called in the legislation a “charitable organization”) to deduct all expenditures for public benefit purposes.¹³ PBOs are treated as conducting “charitable businesses.” If a PBO retains more than 25% of its total receipts without dedicating them to charitable purposes, it will be subject to tax.¹⁴ This is a novel approach and one that will warrant further research as it begins to be applied.

With respect to membership dues, the theory behind the rule for exclusion from income is somewhat different. Membership dues may not be considered to be income of an NPO in part because the NPO owes the members services in return for the receipt of the dues. In addition, unlike charitable gifts, membership dues are generally not deductible to the payor, nor are the membership benefits generally treated as income when received. There may, of course, be a timing problem in that member services may not be received in the taxable year in which the dues are paid, but that is ordinarily thought to be an insignificant problem and one that would not warrant the additional complexity of proper accounting over several taxable periods.

2. Income Earned on Investments (Endowments and Reserves).

The same may or may not be true for “passive” investment income. Generally accepted tax theory defines income as any receipt during a defined period of time that is either expended or that increases net worth.¹⁵ Under this approach, and in common

¹¹ See Boris I. Bittker and George Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L. J. 299 (1976).

¹² The value of the charitable contribution deduction in a progressive rate system depends on the taxpayer’s highest marginal rate. If a person is taxed at a 40% rate and contributes \$100 to a charity, she reduces her taxes by only \$40, not by \$100.

¹³ This new tax law came into effect on 1 July 2004. Under it, set-asides for future charitable activities are also deductible. How the rules with respect to set-asides are to be applied by the Commissioner of Income Tax has yet to be decided.

¹⁴ See Tanzania report in IJCSL-N for August 2004.

¹⁵ See R.M. Haig, *The Concept of Income*, in THE FEDERAL INCOME TAX 1, 27 (1921); Henry Simons, PERSONAL INCOME TAXATION 50 (1938).

understanding, it is clear that all items of “passive income” – interest, dividends, rents, royalties, and gains from the sale of assets -- are generally considered income for tax purposes.¹⁶ Many countries exempt PBOs, but not NPOs, from taxation on passive income. France and countries that follow the French system of tax rules for NPOs, tend to tax passive investment income of all taxpayers, with a variety of exemptions available for different kinds of PBOs. The dividend and interest income of NPOs is subject to tax in the U.K., but an exemption for interest income can be sought in Ireland.¹⁷ In the United States passive investment income of PBOs (public charities and private foundations) is not subject to tax.

In the countries of Central and Eastern Europe as well as in some countries of Africa, the question has arisen whether interest and dividends earned on invested assets that constitute an organization’s endowment or reserves should be taxed.¹⁸ In Madagascar, for example, the investment income of a PBO is taxed, consistent with the practice in Francophone countries of taxing the passive income of all taxpayers. As already indicated, however, France grants a set of special tax exemptions for the investment income of PBOs, but these rules do not seem to have found their way into the Malagasy legislation.¹⁹ Exemption of the income of PBOs is undoubtedly a good rule, since taxing investment income inhibits the creation and continuation of endowments, which are crucial to the support of the not-for-profit sector.

With respect to endowments other issues arise as well – these include the ways in which endowment funds are invested and how to guard against unreasonable

¹⁶ In Romania, however, interest is deemed to be “without economic character” and therefore not subject to the profits tax. See Ministry of Finance Methodological Rules No. 5910 of 1991. Obviously, if interest income is not generally taxed, as in the case of Romania, NPOs should not be taxed on their interest income.

¹⁷ See Joe Ryan, *Reliefs from Tax on Income and Property of Charities in Ireland* (1995).

¹⁸ It is often relevant to focus on the kinds of activities conducted by NPOs in deciding whether to exempt income from investments. For example, an excellent report that focuses on issues in the Asia-Pacific region, states that “It is particularly important that NPOs carrying out “watchdog” functions through policy research, lobbying and public awareness-raising be financially independent of both their own governments and foreign donors. To encourage such independence, dividend income on NPOs’ financial endowments could be made tax-free. NPOs providing services to other NPOs (e.g., as “umbrella” organizations, as federations, or as subcontractors) or those playing a catalyst role on behalf of the NPO community could also be given that concession on income from all funds held in trust.” See ESCAP, *FISCAL INCENTIVES*, supra note 4.

¹⁹ Under the Code Général des Impôts [General Tax Code] of Madagascar, the 25 % tax on revenues from movable property is imposed on all organizations with their seat in Madagascar. Exemptions for public benefit organizations were repealed in 1998 and have not been reinstated. See Madagascar File, in the ICCSL library.

accumulations. In some cases the tax laws address these issues. For example, in both the Czech Republic and Serbia special rules exist with respect to the investments that may be made by foundations, and in the Czech Republic the rules are very restrictive.²⁰ Limitations with respect to the types of investments that may be made by foundations or other NPOs are intended to limit the risk involved in certain types of investments. On the other hand, imposing restrictions that are too severe may unnecessarily impede the growth of an endowment – for example, when the law only allows investment in government bonds, the growth rate of the endowment may well not keep pace with inflation. The more modern approach to investment limitations is a “prudent investor” standard.²¹

It is also important to have rules that require foundations to spend their income (and, perhaps, their assets) for programmatic purposes. In order to avoid unreasonable accumulations by endowed organizations, a good approach is to adopt a rule in the tax law that requires minimum distributions or spending of the earnings, as in the United States, Canada, or Germany.²² Such rules generally impose a penalty tax if the earnings are not spent within a specified amount of time.²³

3. Income or Profits Taxation of Economic or Business Activities.

²⁰ See “Survey of Tax Laws Affecting NGOs in Central and Eastern Europe, Second Edition,” (hereinafter CEE Tax Survey) <http://www.icnl.org/programs/cee/pubs/taxsurvey/Default>.

²¹ See Marion Fremont-Smith, GOVERNING NON-PROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION (Harvard University Press 2004), at 454. Modern investment standards also allow a “portfolio approach,” under which investments must be diversified and may include some investments with higher risk/reward potential.

²² See 26 U.S.C. § 4942, a provision of the U.S. Internal Revenue Code that imposes a tax on private foundations that fail to distribute a minimum amount of their investment income (equal to approximately 5% of assets) for public benefit purposes. The rules in Germany are explained in Michael Ernst-Poerksen, Basic Conditions of Corporate and Tax Legislation Affecting the Third Sector in Germany, in the October 2003 issue of the INTERNATIONAL JOURNAL OF CIVIL SOCIETY LAW, available at www.law.cua.edu/students/orgs/IJCSL/. The rules in Canada and possible amendments to them are discussed in the April 2004 issue of the INTERNATIONAL JOURNAL OF CIVIL SOCIETY LAW, available at www.law.cua.edu/students/orgs/IJCSL/. Rather than requiring distribution of a fixed percentage of revenues or assets, account should properly be taken of the facts that investment returns and inflation rates vary greatly. One good approach is to require distribution of one-half of real, inflation-adjusted income every year.

²³ The approach adopted in 2004 in Tanzania and described supra in the text generally follows the approach in Germany outlined in the article cited in note 18; it permits a PBO to retain up to 25% of its receipts tax free in any year. In addition, section 64 of the Income Tax Law also permits a PBO to seek a ruling from the Income Tax Commissioner that retained set-asides for future projects may be considered to be current expenditures for tax purposes.

Economic or business activities of NPOs raise two different questions: 1) to what extent should NPOs and PBOs be allowed to conduct such activities; and 2) how should profit from such activities be taxed? Business activities conducted by NPOs and PBOs may be conducted to carry out the organization's not-for-profit purposes (museum entrance or school tuition fees, for example), or they may be engaged in solely to gain revenue for support of the NPO or PBO.²⁴ In general, both NPOs and PBOs are allowed to engage to an unlimited extent in income-producing activities that further the not-for-profit purposes stated in their governing documents. As to NPOs that are not PBOs, a test of whether the business activities further the not-for-profit purposes of the organization is essential to distinguishing proper NPOs from for-profit enterprises. If business activities that are unrelated to the not-for-profit purposes predominate, the "NPO" is really not an NPO and should be required to re-register as a for-profit entity. This is widely known as the "*general purpose*" test -- the purposes of an NPO must generally be not-for-profit purposes.

The importance of determining whether business activities do or do not further the not-for-profit purposes of an organization can be seen even more clearly in the rules applicable to PBOs in most countries. Generally an NPO may qualify as a PBO *only* if it does not engage more than insubstantially in activities, including economic or business activities, that are not in furtherance of its public benefit purposes – this is known as the "*exclusive purpose*" test.²⁵ What this means is that a PBO is permitted to engage in activities unrelated to its public benefit purposes only to a very limited extent.²⁶ Further, the "*exclusive purpose*" test requires that if a PBO is going to conduct substantial income-producing or economic activities, those activities must be in furtherance of the not-for-profit, public benefit purposes of the organization.

The "*general purpose*" and "*exclusive purpose*" tests are mechanical tests.²⁷ Thus, if more than 50 percent of the activities and expenditures of an NPO constitute non-purpose-related activities for a significant period of time (e.g., 3 years) the organization

²⁴ For activities to constitute business activities, there must be an "active conduct of a trade or business, which means the regular, repeated, or continuous conduct of an income-producing activity over a substantial time. Thus, profits from ad hoc or "one-off" fund raising events such as raffles, charity sales events, etc., are generally not treated as business activities and are not taxed.

²⁵ E.g., § 501(c) (3) of the U.S. Internal Revenue Code.

²⁶ What is small enough to not violate the requirement of the not-for-profit purpose being "exclusive" varies from country to country. In general, however, "exclusive" does not mean 100%.

²⁷ See infra text at note 36 for a discussion of other forms of mechanical tests.

should be required to be reclassified as a business entity. And, an organization cannot qualify as a PBO if it engages to more than an insubstantial extent in activities, including business activities, that do not further its public benefit purposes. As long as any amount of “related” economic activities are permitted for both NPOs and PBOs, tax can properly be imposed on profits from all unrelated economic activities.

Within these generally accepted rules for whether and the extent to which NPOs and PBOs may engage in business activities, research shows that the taxation rules for economic or business activities vary considerably from country to country. There are essentially five different possibilities for taxing such income that are in use around the world:

- Any net profit or surplus earned by an NPO from the active conduct of income-producing trade or business activities may be --
- a. exempted from income taxation;
 - b. subjected to income taxation;
 - c. subjected to income taxation only if the activity constitutes a trade or business that is not related to or is not in furtherance of the not-for-profit purposes of the organization;
 - d. subjected to income taxation under a mechanical test that allows a modest amount of profits (e.g., 10% of overall revenues) from economic or business activities to escape taxation, but tax is imposed on all revenues from such activities in excess of the limit; or
 - e. subjected to income taxation under a complex rule that combines some aspects of more than one of the preceding rules.²⁸

The issues involved in selecting among these possible tax rules are complex and technical. Alternative (a) is a “*destination of income*” test. Under such a test, all income from all economic or business activities would be exempt from tax, but only so long as all of the profits earned from the income-producing activities are used or set aside to carry out the principal not-for-profit purpose for which the NPO was formed. In such a

²⁸ Some countries also look to the aspect of the “commerciality” of the economic activities – is the income derived from an activity that is conducted in competition with the business sector and in a commercial manner. For example, France has developed a set of complex tests that provide for such a rule. See Caroline L. Newman, *Recent Ministerial Instructions Regarding the Tax Treatment of NPOs*, 2 INT’L J. NOT-FOR-PROFIT L. 2 (March 2000), at www.incl.org/journal/vol2iss2/cr_weurope.htm#FRANCE. Recent legislation in South Africa also looks to the commerciality issue in some cases; see *infra* note 37 for references.

case, a tax exempt NPO would not pay tax on any income from any business activities so long as it dedicated all of its profits to its not-for-profit purposes.²⁹

In a country with a developing market economy, it may be appropriate to strike the balance in favor of a “*destination of income*” test for *all* profits used or set aside by a PBO to carry out its purpose-related activities.³⁰ Countries in which the market economy is still young are generally also countries where civil society is just beginning to flourish. PBOs in such countries are often desperate for money simply to survive, and the profits from economic or business activities may make the difference between their continued existence and termination. In such countries it is also possible to argue that there is such a strong need to develop economic activities independent of the state that all entities, whether NPOs or business entities, ought to be encouraged to engage in them. In such a context the destination of income does not involve any tax abuse, provided there is a firm and effective ban on any direct or indirect distribution of profits.

In countries with a more fully developed market economy, the problem of unfair competition can become a serious issue, particularly when the scale and number of economic activities by NPOs begins to pose a threat to private enterprises. Obviously, if a large and wealthy NPO can engage in a particular activity (e.g., book publishing) without paying taxes, it has an economic advantage over its for-profit competitors. When this issue becomes significant for the fiscal policy of a country, the obvious solution is to tax such profits.³¹ Some countries (e.g., France) do so if the NPO is operated on a commercial basis and in fact competes with for-profit companies.³² Other

²⁹ If the active trade or business is carried out indirectly, through a subsidiary, the legal system might regard the subsidiary as a for-profit business entity, but simply exempt it from income taxation if it gave all its profits to the NPO. See discussion of this tax benefit in Appendix B. The result is the same: the activity is permitted and the profits are not taxed. Although both associations and foundations in Poland receive the benefit of a destination of income rule, associations must engage in economic activities through a wholly owned subsidiary, whereas foundations are exempt from tax on activities that they carry out directly. See *Country Report – Poland*, available at www.usig.org.

³⁰ In practice such a test has only been applied to PBOs and not to NPOs in general. For example, the destination of income test was used in the U.S. for “charitable organizations” up to the changes made by the Revenue Act of 1950, which introduced the “unrelated business income tax.” In Poland, where such a test continues to apply, it is only applicable to public benefit foundations. See *Country Report -- Poland*, available at www.usig.org.

³¹ For a useful analysis of the issues related to taxation of profits from economic activities, see Industry Commission, CHARITABLE ORGANIZATIONS IN AUSTRALIA, 311-312 and Appendix J (1995).

³² The “commerciality” test as it applies in France and South Africa is discussed in a separate paper by the authors.

countries (e.g., the United States³³) tax income from such economic or business activities only if they do not further the public benefit purposes of the NPO (“unrelated trade or business income”).

A rule (see c. above) taxing “*unrelated business income*,” as in the United States, and exempting the profits from “related” activities, makes a great deal of theoretical sense. Often the most effective way for a PBO to achieve its purpose is to pursue it through economic means. For example, the most effective way to disseminate information about a particular kind of art, culture, or scientific knowledge that a PBO wants to promote may be to publish and sell a high-quality magazine devoted to the topic.³⁴ If the “exclusive” purpose of the organization is to promote the particular kind of art, culture, or scientific knowledge, and if no profits are distributed directly or indirectly,³⁵ then exempting from taxation the profits from publication and sale of the PBO’s magazine may make good tax policy sense.

Unfortunately, it is extremely difficult to distinguish “related” economic activities from “unrelated” economic activities, and hence the related/unrelated rule is very difficult to administer in practice. For example, if a museum sets up a shop on its premises to sell prints, postcards, or books that replicate the outstanding works of art in its collection, this can easily be argued to be “related” to the museum’s purpose. But what should happen if the museum opens a chain of retail stores that sell books related to art and culture, most of which are not in its collection? Is it engaging in an “unrelated” activity, or has it simply broadened its purpose and chosen to pursue the broader purpose using economic means? What if the museum operates a café or restaurant on its premises for the convenience of its patrons and in order to encourage greater attendance. Would profits from such an activity be “related” or “unrelated”? Designing administrable rules for making the related/unrelated distinction, which adequately respond to all relevant considerations is not easy. The amount of revenue raised by the U.S. tax on “unrelated” business activities, however, indicates either that

³³ This is the rule used in the United States, under sections 511-514 of the Internal Revenue Code, 26 U.S.C. § 511-514. Both the law itself and the regulations issued thereunder are very detailed and complex. See Leon E. Irish, Provisions of the United States Tax Laws Affecting Not-for-Profit Organizations in Ambrosianeum Foundation, GOVERNANCE AND TAXATION OF PUBLIC BENEFIT NONPROFIT ORGANIZATIONS (Milan, 2002) for a discussion of these rules.

³⁴ E.g., National Geographic, which generates hundreds of millions of dollars of income for the National Geographic Society, a U.S. public charity that is exempt from taxation on this income.

³⁵ One indirect way to distribute profits is to pay excessively high salaries. Thus, one of the criteria used in France for distinguishing between taxable and nontaxable income from economic activities is whether the managers receive more than a minimal salary. See Caroline L. Newman, *op. cit.*, note 24, *supra*.

the distinction can be effectively made or applied with the result that significant tax revenues are raised from unrelated business activities.³⁶ From the amount of revenue raised it is clear that some PBOs in the U.S. are willing to engage in unrelated economic activities to support their public benefit purposes even at the cost of paying regular corporate income taxes on the profits from those activities.

To the extent that economic activities (e.g., publication of magazines or of books) are simply the chosen means by which most effectively to pursue a given end (e.g., promotion of art or culture), one could be said to have come back to a kind of “*destination of income*” test, under which related economic or business activities can constitute the entire active work of a PBO as long as all profits go to a proper public purpose.³⁷ But, as applied in most countries that use it, a real “*destination of income*” test applies to all income-producing activities, not merely to those that are in furtherance of the organization’s not-for-profit purposes.

One possible alternative, used in Poland until the mid-1990’s, would permit a PBO to be exempt from tax on profit from any economic or business activities (both purpose-related and regular business activities) as long as that profit was spent for carrying out the public benefit purposes within the year of receipt or the next succeeding tax year. By preventing undue accumulations of profits, this rule may be a useful modification of the “pure” destination of income test, but it nevertheless suffers from the

³⁶ See James R. Hines, Jr., *Nonprofit Business Activity and the Unrelated Business Income Tax*, NBER Working Paper No. w6820, issued November 2000, published in *TAX POLICY AND THE ECONOMY* (Poterba, ed.) (Cambridge: MIT Press, 1999), vol. 13, pp 57-84. In 2001 the Internal Revenue Service collected over \$650,000,000 in revenue from the unrelated business activities of tax exempt organizations. See <http://www.irs.gov/pub/irs-soi/02db01co.xls>. For an earlier discussion of the same issues, see Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605 (1989).

³⁷ A strong argument can be made that such a test in fact applies to health, cultural, and educational organizations that cover their costs from the fees they charge. When such an organization earns a profit or surplus, it is plowed back into the organization and used for its not-for-profit purposes. Such an organization is different from a commercial organization that engages in similar activities but distributes profits to shareholders because it cannot distribute or accumulate for distribution any profits it earns. Further, most such health, educational, and cultural not-for-profit entities usually render substantial services free of charge or at a reduced rate to some poor individuals, which provides another basis for treating them as deserving of tax exemption on any profits they may occasionally earn. On the other hand, the question of whether private schools that charge high tuition fees qualify as public benefit organizations has been raised in the context of the current discussions in Great Britain under the new “Charities Bill.” See <http://society.guardian.co.uk/charityreform/story/0,11494,1256061,00.html>.

Of course, if the fees paid to a PBO never exceeded its costs, there would be no profits to tax, and it would be irrelevant whether the organization was regarded as tax exempt or not.

necessity of distinguishing between money that was earned this year or last rather than in an earlier year.³⁸

A *mechanical test* for determining the difference between taxable economic activities and nontaxable economic activities almost surely constitutes a simpler system for taxing NPOs. It would be possible, for example, to tax profits from all economic or business activities but only if and to the extent they exceed a certain figure or a percentage of all revenue. In Hungary, which has adopted this approach, NPOs are exempt on the net profits from all business activities – whether related or unrelated -- if the annual profit from such activities does not exceed the lesser of 10 million forint or 10% of total revenue. This works fine as a tax rule, for the only consequence of exceeding the minimum in any year is that taxes must be paid on actual profits. In Hungary, however, taxes are levied on all profits from business activities if the threshold is exceeded, whether the activities are related or not, and not just on the excess over the threshold. This is presumably on the theory that if the organization has a lot of business activity income it is more like a business than an NPO.³⁹

One aspect of the rules applicable to business income in South Africa is similar to the mechanical test used in Hungary – South African PBOs may engage in “trading” activities tax free so long as the income generated from those activities does not exceed the greater of 15% of gross receipts or ZAR 25,000.⁴⁰ But if the threshold is exceeded and the other qualifying tests are not met, public benefit status is entirely lost; this is a much harsher outcome than that in Hungary.⁴¹

As this discussion makes clear, allowing PBOs to engage in related business activities to any extent and in unrelated business activities only to a limited extent is the pervasive custom around the world. The rule that NPOs should be re-registered as business entities if they are predominantly engaged in business activities is also widely accepted. The rules applicable to taxing income from business activities of NPOs and PBOs, however, vary considerably from country to country.

³⁸ Poland has now gone to a pure destination of income test. See Corporate Income Tax Act, CIT Article 17(1),(4),(5). Germany also has a rule similar to the former rule in Poland, and it was retained and amplified during the last round of tax changes in summer 2000. See Michael Ernst-Poerksen, *op cit*, supra note 18.

³⁹ For further discussion of this and other mechanical tests, see *CEE Tax Survey*, supra note 16.

⁴⁰ The relevant test in South Africa can be found in Section 30 of the Income Tax Law, available at http://www.sars.gov.za/it/pbo/section_30.pdf.

⁴¹ *Id.*

4. Political Activities of Tax Exempt NPOs.

The issue of whether tax or other laws restrict the political activities of NPOs has not been well-researched in recent years. There has been a tendency, as exemplified by a paper that International Center for Not-for-Profit Law (ICNL)⁴² published in 1996 entitled “*Public Policy Activities of Not-for-Profit Organizations*,”⁴³ to note differences between common law countries and civil law countries with respect to political activity restrictions. Common law countries are said by the paper to have more limits on political activities of NPOs than do civil law countries. As the paper notes, common law jurisdictions classify organizations not by the type of legal person they are but by what they do. In common law jurisdictions, “charities” are not generally permitted to engage in political activities, and the tax laws in those countries tend to reflect this approach principally by limiting political activities of charities or public benefit organizations.⁴⁴

Contrary to the assertion of difference in the paper, however, when one looks carefully at the tax rules applicable to political activities of NPOs in many civil law jurisdictions, there is a great deal of similarity between the common law and the civil law. In France, for example, the tax law and the administrative law both define organizations that are entitled to specific benefits (organizations of “general interest” in the tax law and organizations of “public benefit” (*utilité publique*) in the administrative law). Neither type of organization may engage primarily in political activities.⁴⁵

In Germany the restrictions on the political activities of “public benefit organizations” can be found in the regulations under the general tax law. These regulations state quite clearly that political purposes “are fundamentally not” public benefit purposes. On the other hand, “political” is fairly narrowly defined by the regulations. Although it specifically includes trying to influence public opinion and supporting political parties, the regulations go on to say that a certain amount of “influencing public opinion” is permissible for “public benefit” organizations. In fact, it

⁴² The authors are co-founders of ICNL and also of the International Center for Civil Society Law (ICCSL).

⁴³ *Public Policy Activities of Not-for-Profit Organizations*, prepared for the Conference “Regulating Civil Society 3,” held in Budapest Hungary in 1996. See <http://www.icnl.org/library/cee/docs/pubpol.html>.

⁴⁴ In England charities may engage in “lobbying” or “campaigning” if it is incidental to and in pursuance of their principal purpose. See *id.*, for a discussion of the rules in various common law jurisdictions.

⁴⁵ See *Country Note: France – the Status of Political Activities of Associations and Foundations*, 3 Int’l J. Not-for-Profit L. 3, http://www.icnl.org/journal/vol3iss3/cr_weurope.htm#FRANCE (March 2001).

is permissible so long as the accomplishment of a public benefit purpose is linked with setting a political goal, and the actual attempts to influence the political parties and the state are not foremost in what the organization does. The regulations cite a specific case, which held that an organization could take a specific political position, consistent with its public benefit purposes, so long as that was not its primary activity.⁴⁶ In contrast, an organization that has a political goal as its only or its primary purpose would not qualify as a public benefit organization.

As this brief discussion makes clear, tax laws in both common law and civil law jurisdictions frequently restrict political activities of organizations that receive special tax preferences. In general, however, such restrictions are tied to the level of tax benefits received. The theory for imposing such restrictions is one of subsidy (e.g., the public treasury should not subsidize the political activities of anyone, no matter what individual or type of entity is conducting them).⁴⁷ According to this theory, organizations that receive no actual subsidy should have no restrictions imposed by the tax laws on their political activities. In the United States, for example, both social welfare organizations and political parties⁴⁸ – NPOs that are not treated as “public

⁴⁶ The Bundesfinanzhof (Federal Financial or Tax Court) decision that is quoted in the regulations is the decision from 23 November 1988. The decision can be found in the *Bundessteuerblatt* 1989, Part II, page 391. It concerned an organization whose purpose was the promotion of “peace” and the question of whether that purpose could be a public benefit purpose. Generally the court decided that it is, despite not being specifically named in the *Abgaben Ordnung* (AO) or General Tax Law, for promoting peace is close enough to general purposes of education and human development (p. 392).

More specifically, with respect to the question of whether the organization could take positions on matters that are of a political nature, the court noted that an organization may need to take “political” positions in pursuance of public benefit aims (such as the promotion of peace). What this organization did in that context was nonpartisan and it engaged in such activities only for the purpose of achieving its goals. Entering into day-to-day political discussions was not the major focus of the ways in which the organization carried out its purposes. In addition, it made statements in an objective and well-grounded way (even though the language used was at times hyperbolic) (p. 392).

⁴⁷ See *Regan v. Taxation with Representation of Washington*, 461 U.S. 540 (1983). It is recognized, however, that even public charities are entitled to freedom of speech. The U.S. Supreme Court has ruled that making the deductibility of contributions to public charity conditional on their not engaging in electioneering or undue lobbying is valid so long as such organizations are entitled to create and control related tax exempt organizations to which contributions are not deductible but which can engage in electioneering and lobbying activities. See *League of Women Voters v. Commissioner*, 468 U.S. 364, 400 (1984).

⁴⁸ See Internal Revenue Code §§ 501(c) (4) & 527.

charities”⁴⁹ -- are exempt from income tax on their membership dues, but not on other sources of income, such as investment income and income from commercial activities. Public charities under Section 501(c)(3), however, which are permitted to receive tax deductible contributions, may not engage in electioneering (i.e., supporting or opposing candidates for public office) at all nor, except to an insubstantial extent, in lobbying activities. This is similar to the tax rules in Germany and France, as discussed above.

It is also important to note that distinctions can and probably should be made among different types of political activities. Public policy activities that tend to be more like educational or “issue advocacy” activities should not interfere with or threaten the tax exempt status of a PBO. Grass roots lobbying activities – urging citizens to contact their elected representatives on specific issues -- are more “political” in nature and thus might properly be limited when a tax subsidy is available. Electioneering activities (promoting or opposing candidates for public office), though permitted for NPOs in some civil law jurisdictions,⁵⁰ tend to be prohibited for tax exempt NPOs in most countries.

III. Income Tax Rules for Donations to PBOs.

Tax rules that provide preferences for donations to PBOs are important and useful tools for encouraging the sustainability of NPOs that act in the interests of the public and promote social and economic development, culture, health, education, science, etc.⁵¹ In most countries with a developed civil society, individuals and business entities are entitled to an income or profits *tax deduction* or a *tax credit* with respect to donations made to PBOs.⁵² Under either a credit or a deduction scheme, the amount of

⁴⁹ PBOs in the U.S. include both public charities and private foundations. For a discussion of the distinction between the two types of PBOs, see Leon E. Iirsh, *op.cit*, supra note 29.. The rationale for making the distinction is a purely regulatory one.

⁵⁰ In Brazil and Poland, for example, associations may field candidates for public office without registering as political parties. In most countries, however, such activities are confined to registered political parties. The tax laws tend to treat registered political parties differently from public benefit NPOs. For example, donors are usually not permitted to deduct as charitable contributions donations to a political party.

⁵¹ For a longer discussion of the design of tax rules for donations, see Paul Bater, *Evaluating Incentives for Donations to Public Benefit Organizations*, 2 INT’L J. NOT-FOR-PROFIT L. 3 (Dec. 2000), available at www.icnl.org/journal/vol3iss2/ar_bater.htm. See also, Karla W. Simon, *Creating an Enabling Environment for Development Partnerships*, Inter-American Development Bank, 1997.

⁵² Although almost every country surveyed grants at least some tax benefit for donations, some countries, e.g., the Nordic countries, grant very few. Of course these countries provide rather substantial grants in aid from government to NPOs, which may be seen as making up for the relative lack of tax benefits to private donors. But some experts question the soundness of the

revenue lost is only a fraction of the amount that is donated to PBOs for purposes regarded by the State as important. Thus, although they decrease the amount of revenue flowing directly to the State in tax revenues, the tax preferences for donations increase the revenue going to State-sanctioned “public benefit” purposes.

Other approaches to preferences for donations result in greater amounts going to PBOs without reducing the revenues initially flowing into the State treasury. For instance, the U.K. has a *tax reclaim scheme*, which costs less revenue than a deduction for donations and eliminates fraud, but at the cost of additional complexity. Increasingly, countries in Central Europe are adopting an extra “tax benefit” (in addition to a deduction or a credit) by allowing for *tax designation schemes* (as in Hungary, Slovakia, Lithuania, Poland, and Romania).⁵³ Under such a scheme, the taxpayer pays all of his/her/its taxes to the government, but also sends along a designation form requiring that the government pay over 1% or 2% of the taxes collected to a specified PBO.

In the discussion of income tax exemptions, it was suggested that no NPO should be taxed on donations it receives. If, in addition, the donor is entitled to a tax credit or a deduction against his/her personal or its business income tax, if the NPO is permitted to reclaim the tax benefit the donor would have received, or if the donor can participate in a tax designation scheme, the same donation receives a double tax preference.⁵⁴ This generous tax treatment is deemed justified when the activities of the organization in question are for public benefit.⁵⁵ Of course, if there is a tax preference for contributions to such organizations, there will be great pressure on the tax authorities to classify NPOs as PBOs. This distinction is often difficult to draw, and in actual practice the tax

current situation. See, e.g., Ole Gejms-Onstad, *Tax Benefits for Public Benefit Civil Society Organizations in the Nordic Countries* in Ambrosianeum Foundation, GOVERNANCE AND TAXATION OF PUBLIC BENEFIT NON-PROFIT ORGANIZATIONS (Milan, 2002).

⁵³ A good description of the various tax designation schemes in countries of Central Europe can be found on www.onepercent.hu.

⁵⁴ A tax designation scheme is a little different from a deduction or a credit in that it does not involve a reduction in the taxes paid by the donor but rather involves a direct requirement by the donor that the State treasury must pay a portion of the donor’s taxes to the designated PBO. Of course, the economic effect for the State and PBO is similar in that, like a tax deduction or tax credit, a tax designation scheme reduces the net revenues of the State and results in more money flowing into the PBO.

⁵⁵ India provides an example of a relatively generous tax deduction scheme. In India cash donations to charitable organizations by companies are 50 percent tax deductible, up to 10 percent of gross income. A regional study concluded that in India, “The scheme of deductions for charitable contributions increased the quantum of such contributions substantially. In the absence of incentive provisions, the contributions of companies would have been lower by about 64 percent of the actual contributions.” ESCAP, FISCAL INCENTIVES, *supra* note 4, at 23-24.

authorities tend to proceed on a case-by-case basis, looking at the purposes and activities of each NPO.⁵⁶

As described above, there are essentially four different types of tax rules for donations, *deductions*, *credits*, *tax benefit reclaim schemes*, and *tax designation schemes*.⁵⁷ Tax credits are applied against, and reduce the amount of, tax owed by a taxpayer, while deductions reduce the amount of income that is subject to tax. Tax benefit reclaim schemes and tax designation schemes, on the other hand, involve a payment of the part of the donor's actual tax liability to the designated public benefit organization. In developing the tax rules for donations that a country uses, it is important to weigh considerations of tax equity and to design a system that will encourage contributions in a fair and administrable manner.

The distinction between credits and deductions is of great importance in a tax system with a progressive rate structure. Where rates are progressive, deductions favor higher income taxpayers, who are paying higher rates of tax on larger amounts of income. A system giving a tax credit for contributions allows a contributor to reduce his/her tax by the amount, or a percentage of the amount, of the donation. Because a tax credit has the same absolute value for all taxpayers, as a matter of tax policy it involves is regarded as providing greater horizontal equity – that is, it results in a reduction in taxes in the same amount for all taxpayers. Although the absolute value of a credit is the same for all taxpayers, a credit will reduce the taxes of a lower bracket taxpayer by a larger percentage.⁵⁸

Most countries with progressive rate structures allow deductions rather than credits.⁵⁹ This approach is supported by data show that lower income individuals generally tend to make charitable contributions without regard to their tax impact, and, indeed, other tax rules may preclude them from receiving any tax benefit at all from a

⁵⁶ For a discussion of the issues that arise in making a determination whether an organization is a public benefit organization, see the Model PBO Provisions, available on the ICCSL website at www.iccsl.org.

⁵⁷ A chart comparing the effects of deductions, credits, and tax benefit reclaim schemes can be found in Appendix A.

⁵⁸ See Appendix A.

⁵⁹ Under somewhat complex rules, Canada and Hungary allow either a credit or a deduction to individuals, depending on circumstance. See *CEE Tax Survey*, supra note 16. The United States, on the other hand, has always allowed a deduction rather than a credit, and its practice is consistent with that of most other countries.

charitable contribution.⁶⁰ On the other hand, there are substantial empirical data showing that high income taxpayers are quite sensitive to tax rates and that allowing deductions rather than credits tends to attract more and larger gifts from wealthy donors.⁶¹

If the tax system permits tax *deductions*, it is important to set the limits, if any, on the amount of tax deductions allowable. For example, in Russia individuals can claim deductions only up to 3% of their income, and business entities are limited to 1%. In the United States, by contrast, individuals can claim deductions for up to 50% of their income,⁶² and in Australia there is no limit at all. Although empirical studies show that few business entities contribute more than 1-2% of their income in any given year to PBOs, it is important to have a higher allowable limit to accommodate those businesses that regularly or occasionally give substantially more. To provide encouragement for the minority of companies that do give more, it would be reasonable to allow business entities to deduct up to 10% of income.

Individuals do not have the same constraint to maximize value to shareholders that business entities have. Where there is no limit on allowable deductions to PBOs, it is possible for wealthy individuals to avoid paying any taxes at all by contributing to charity an amount equal to their taxable income each year. In a democracy, however, it

⁶⁰ In the United States, for example, individual taxpayers must choose between claiming the “standard deduction” or itemizing all deductible expenses. For lower bracket taxpayers the standard deduction tends to be more valuable, but by choosing it a taxpayer is precluded from listing, and hence from deducting, actual gifts made to charity. As a result, nearly 70% of individual taxpayers receive no direct tax benefit for donations to charities. At present, however, tax reform proposals contain provisions that would allow non-itemizers to claim a charitable contribution deduction within fairly narrow limits.

In other countries individuals who earn wages or salaries do not file tax returns because taxes are simply subtracted from their wages. In such situations it is difficult to claim a deduction or a credit if a charitable contribution is made. The “Give As You Earn” scheme in the UK deals with this problem by a rebate to a designated charitable organization rather than a deduction or credit for the donor. That is also true of tax designation schemes – anyone can participate even if they pay taxes entirely through withholding on wages. See text at note 63 ff, *infra*.

⁶¹ See, e.g., Charles Clotfelter, *Tax Incentives and Charitable Giving: Evidence from a Panel of Taxpayers*, 30 JOURNAL OF PUBLIC ECONOMICS, 319 (1980); Richard Steinberg, *Taxes and Giving*, 1 VOLUNTAS 61 (1990); Kevin S. Barrett, Anya M. McGuirk and Richard Steinberg, *Further Evidence of the Dynamic Impact of Taxes on Charitable Giving* (1996). This conclusion is borne out by recent statistics in the U.K., which indicate that there was a rise in charitable giving by wealthy donors after new legislation allowing tax deductions was instituted (see discussion of this issue in IJCSL-N for July 2004). See also the discussion of new tax legislation in Singapore in text at note 60, *infra*.

⁶² The limitations in the United States are considerably more complicated than can be addressed here. See Leon Irish, *op. cit.*, *supra* note 29.

is generally appropriate for citizen to bear a fair share of the costs of government if he/she is able to, and it is therefore not generally thought appropriate to allow unlimited deductions. At the same time, if deductions are limited to contributions to PBOs -- i.e., organizations contributing to the public good and often relieving the burdens of the State -- generous deduction limits (e.g., 50%) are appropriate.

One recent change in the tax laws in Singapore is worth noting here. Effective on January 1, 2002, Singaporean taxpayers were permitted to double the amount of money contributed to approved charitable organizations, called Institutions of Public Character (IPCs), and deduct that amount from their taxes in the next succeeding tax year. Not all donations receive the double tax benefit (those that provide naming opportunities, for example, do not), but statistics released by the Internal Revenue Authority of Singapore for the 2002 tax year show that the double deduction resulted in a one-third increase in charitable giving.⁶³

With respect to *tax credit* schemes, the situation in Canada is an interesting one. Canada offers a two-tier tax credit system, which gives high marginal rate taxpayers a credit equal to a deduction while offering to those in lower brackets a credit worth more than a deduction. This scheme, which is not nearly as complex as it sounds, has not led to any significant decrease in tax revenues since it began being implemented in 1988.⁶⁴

The use of *tax benefit reclaim schemes* seems to be limited to the UK. In general this type of preference does not provide a direct incentive for donors because it does not reduce their taxes, but it is valuable to individual taxpayers who plan their donations carefully. A donor can ensure that the charities will receive the amount s/he wants them to receive by making a contribution directly to the charity in an amount net of the tax that would otherwise have been payable on the gross amount of the intended transfer. The charity then collects the amount of tax paid by the donor on the gift from the Inland Revenue Service.⁶⁵ The United Kingdom amended its legislation in 2000 to make the rules simpler to apply and to remove monetary limits on Gift Aid and payroll giving. The "Give As You Earn" scheme, which permits individual wage-earning taxpayers to set up a tax reclaim account, is very popular and seems to be administered in a fairly straightforward and easily understandable fashion. Other countries have not

⁶³ For further discussion of this change, see the August 2004 issue of IJCSL-N and the authorities cited there.

⁶⁴ See Carl Juneau, *Charity and Taxes in Canada* (1996), on file with ICCSL.

⁶⁵ See Paul Bater, *Tax Benefits for Public Benefit Civil Society Organizations in the United Kingdom*, in Ambrosianeum Foundation, GOVERNANCE AND TAXATION OF PUBLIC BENEFIT NON-PROFIT ORGANIZATIONS (Milan, 2002), where the mechanics of such a scheme are explained.

chosen to adopt the U.K. tax benefit reclaim system, perhaps because of its complexity, but it has the double advantage of costing the government less revenue than a deduction scheme and greatly reducing the risk of tax abuse.⁶⁶

In addition to these tax rules, Hungary, Slovakia, Lithuania, and Romania, and possibly Poland⁶⁷ have created “*tax designation*” laws, which permit taxpayers to direct that a small percentage of the taxes they pay in a given year be paid over to NPOs designated by them.⁶⁸ By providing a simple mechanism for directing tax funds to NPOs, the “1 % Law”⁶⁹ in Hungary, which has been in operation since 1996, enabled nearly 45% of taxpayers to designate nearly 10 billion forint (about _ 39 million)⁷⁰ to support socially beneficial activities.

IV. VAT or GST Rules.

Many activities of NPOs can be given preferential treatment under a value added tax (VAT) or a goods and services tax (GST),⁷¹ although the precise range of preferences varies from country to country. For example, in Germany the rules were traditionally

⁶⁶ Id.

⁶⁷ Although the new Polish law is called a “one percent” law, the available, unofficial, and incomplete translation reads as if it were a tax credit scheme.

⁶⁸ For further discussion of the different countries, see *CEE Tax Survey*, supra note 16. For a discussion of recent developments with respect to Slovakia, Lithuania, Romania, and Poland see N. Bullain, *Percentage Philanthropy and Law*,

http://www.onepercent.hu/Dokumentumok/Chapter_2_ECNL.doc. (2004). See also Igor Golinski, “Poland’s One Percent System,” http://www.onepercent.hu/Dokumentumok/Chapter_4_Golinski_Pl.doc (2003).

⁶⁹ See I_tvan Csoka, *Hungarian Tax Designation Scheme – the “One-Percent Rule*, 1 INT’L J. NOT-FOR-PROFIT L. 1 (Sept. 1998), at http://www.icnl.org/journal/vol4iss4/cr_cee.htm; Gabor Posch, *How Hungary’s One Percent Law is Applied*, http://www.onepercent.hu/Dokumentumok/Chapter_4_Posch_Hu.doc (2003).

⁷⁰ See Tamas Bauer, *Hungary’s One Percent Law – Why?*, http://www.onepercent.hu/Dokumentumok/Chapter_1_Bauer_Hu.doc. (2003): “In 2003, close to 1.5 million out of the 4.5 million taxpayers in Hungary (nearly one third of income tax payers) decided to use the 1% option and allocated over 6 billion forints (over 23 million euros) to organisations such as associations and foundations, and also to cultural institutions this way. More than 600,000 people did likewise to support the running costs of their church with just under 3 billion forints (over 12 million euros). A further 140,000 people who did not wish to support a church chose instead to designate over 800 million forints (over 3 million euros) to special purposes earmarked in the national budget (this year, anti-ragweed and health-care programmes). In sum, over 2 million designations were made to almost 22,000 beneficiaries totalling nearly 10 billion forints (about 39 million euros).”

⁷¹ GST is the terms used for VAT in some countries, e.g., Canada and Australia.

quite broad, but now, with VAT harmonization slowly progressing in the European Union, the range of preferred activities is smaller.⁷²

The design of VAT rules is important for NPOs. If an organization is excluded from a VAT system by not being defined as a “taxable person” or by being exempt (which would be true of most NPOs), it pays VAT on goods and services it buys from others, for the tax is built into the price it must pay (input VAT). However, since it is not in the VAT system, as an excluded organization it cannot apply for a rebate or claim a deduction for the input VAT when it sells its good or services. In short, an excluded or exempted organization is treated like a final consumer and bears the full burden of the VAT or GST.⁷³ Although exclusion from the VAT system is thus not usually desirable from a tax point of view, NPOs may still rationally prefer it in order to be relieved of compliance burdens. But, this will mean paying the VAT or GST on all goods and services that are purchased by the NPO.

For PBOs that are willing to deal with the compliance burdens, a better economic solution would be to elect to be included in the VAT system⁷⁴ and for the system to permit them to be zero-rated with respect to the goods and services they provide that are in furtherance of their public benefit purposes. This would mean that, although the PBOs would pay input VAT on the goods and services they buy, they would not have to collect output VAT because they would be zero-rated on their outputs.⁷⁵ They could then receive a rebate of, or offset for, the input VAT paid. This would constitute a rather significant tax subsidy, and the approach is therefore not adopted in most countries.⁷⁶ The more general approach, and the only approach allowed in the European Union and countries seeking accession to it, is to reduce the potential revenue loss by imposing a more favorable VAT rate, but no lower than 5%, on certain socially desirable goods and

⁷² See Sixth Council Directive of the European Community 77/388/EEC of 17 May 1977 on “The harmonization of the laws of the Member States relating to turnover taxes; a common system of value added tax and a uniform basis of assessment.”

⁷³ For further discussion of this problem, see Gejms-Onstad, *op.cit.*, supra note 49.

⁷⁴ Some NPOs would necessarily be included in the system because their economic activities are substantial. Most countries have a threshold amount of turnover that must be met before a legal entity is included in the VAT system, but most countries also allow entities that have outputs below the threshold to opt into the VAT system if they wish to. See David Williams, *Value-Added Tax*, in Victor Thuronyi (ed.), *TAX LAW DESIGN AND DRAFTING* (IMF 1996).

⁷⁵ Of course if the NPO were engaged in unrelated income-producing activities, it would need to treat that aspect of its activities separately from the zero-rated activities.

⁷⁶ In Bangladesh, Indonesia, the Philippines, and Thailand, NPOs receive no exemption from the VAT, but in some cases they benefit from lower rates levied on primary, unprocessed agricultural products. See Derek Allen, *VAT in the European Community* (1994).

services, such as medicines and health services, which are often provided by public benefit organizations. For example, if the general rate of VAT is 20%, the special rate for listed goods and services might be 5 -10%.⁷⁷ The lower rate of VAT makes the preferred goods and services cheaper for the ultimate consumer, and it also allows the provider of them to claim a rebate or credit for some of not all of the input VAT it paid in connection with them, up to the amount of the output VAT on the preferred items.

Another approach that would lift much of the heavy burden of VAT would be to allow PBOs that have paid a net amount of VAT during a year in excess of an appropriate threshold amount, to apply to the government for a grant equal, say to 75% of the net amount of VAT paid. This subsidy would be in the form of a grant instead of tax relief, but it would amount to the same thing.

V. Customs Duty Rules and VAT on Imports.

Customs duties and import VAT are among the most contentious and difficult tax issues faced by NPOs in practice. Even if the law of a particular country provides for exemption for PBOs from both customs duties and VAT on imports related to the organizations' public benefit purposes, customs officials often disregard the law, and PBOs must often spend a disproportionate amount of time dealing with customs officers to actually receive the benefit of their exemptions.⁷⁸ At the same time, it is understandable that tax officials are cautious, for allowing customs and import VAT exemptions for PBOs sometimes attracts charlatans and crooks into the NPO sector with the prime motive of using a fake NPO⁷⁹ to obtain exemptions on the import of certain goods.

If customs duties and import VAT are imposed on legitimate PBOs, however, they can dramatically increase the costs of operations. This difficulty faces both foreign and domestic PBOs. It can be particularly severe for humanitarian relief organizations that typically must import all of their goods and services in order to meet emergency relief needs. It is an added problem that most bilateral and multilateral funders of humanitarian relief and development projects forbid any of their funds to be used to pay

⁷⁷ For a fuller discussion of VAT issues, IMF, *THE MODERN VAT* (2002); see also, Williams, *op. cit.*, *supra* note 71.

⁷⁸ In Rwanda the only tax benefits for NPOs are exemption from customs duties and exemption for expatriate NPO employees from the entrance fee. Malawi, Kenya, and Uganda, on the other hand, grant a range of customs duty exemptions to NPOs in addition to other tax rules. See *Africa Tax Survey* (1997), on file with ICCSL.

⁷⁹ Called "suitcase NPOs" in East Africa.

host country taxes, making a special tax agreement with that country necessary. Customs duties and import VAT are problems, though, for even the smallest PBO, which might want to import a fax machine or a computer to make its work more productive.⁸⁰

Most countries therefore provide customs duty and import VAT exemptions only to PBOs. But if such exemptions are available, there must also be a fair but thorough process for assuring that only genuine PBOs qualify for the exemption. Countries have generally provided for a certification, licensing, or similar process to ensure that an organization's exemption will be honored at the border.⁸¹ Even certified PBOs, however, may be required to seek specific exemptions for particular goods they want to import.⁸² To protect against the improper use of the exemption, it is also appropriate to provide that imports will be exempt only if they are going to be used by the PBO in its operations. To avoid abuses, if an item is sold by a PBO (e.g., a computer, a truck, or an automobile) within a short period (e.g., 2-3 years) after its import, it should be subject to customs duties and import VAT at the time of sale.

VI. Other Tax Rules.

Depending upon the extent to which a government wishes to encourage NPOs, exemption from, or preferential treatment under, other tax laws (e.g., taxes on real or personal property, sales taxes, estate or inheritance taxes) should be considered. Practices in this respect vary widely around the globe. As one example, Indonesia, Thailand, and the Philippines exempt religious organizations from land taxes, while Australia provides no similar rules for religious organizations. Most countries of

⁸⁰ Often the problem is not the absence of an exemption for NPOs, but the red tape involved in claiming it. In India NPOs wishing to obtain concession from duties imposed on equipment imports donated by foreigners have to apply for central government approval six months in advance, and strict rules and procedures are invoked under the Foreign Contributions Regulation Act (FCRA). In Sri Lanka and the Philippines exemption from customs duties and the VAT on donations from foreign sources can be obtained only if the donations are consigned to the relevant government agency. These kinds of procedures generally involve numerous bureaucratic obstacles, conditionality provisions, and opportunities for rent-seeking. See, ESCAP, FISCAL INCENTIVES, supra note 4.

⁸¹ Exemption at the border, however, offers serious possibilities for corruption. See Williams, *op.cit.*, supra note 71.

⁸² In Timor-Leste a certified PBO must file detailed financial and tax information each time it wants exemption for goods to be imported, and the Revenue Service may do a site visit to determine whether there is a need for the item in the programs of the PBO. Tax rules for Timor-Leste, on file with ICCSL.

Central and Eastern Europe give different types of real estate tax benefits to NPOs.⁸³ Most countries have a variety of additional tax or rate rules for NPOs, generally limiting them to PBOs and/or to the public benefit activities of other NPOs.⁸⁴

VII. Employment Tax Rules.

Despite the fact that NPO and, particularly, PBO employees typically expect and receive a lower level of compensation than that which is paid for comparable work in the for-profit sector, there is little justification for exempting them from the usual social security and related employment taxes that are exacted from workers in the government or for-profit sectors. Social security and similar taxes are exacted on the basis of actuarial estimates of what is required in order to meet the State's obligations to retired workers over the long term. Those who are employed in the not-for-profit sector should not be excluded from the benefits that are provided for those who participate in these State schemes.⁸⁵

Arguments have been advanced that NPO workers are paid less than workers in the for-profit sector, and that they should therefore be exempt from social security taxes or pay them at a reduced rate. Although it is a valuable tax preference to provide exemptions for NPOs from most forms of regular taxation, to exempt NPO employees from social security taxes while including them in the benefits of such systems (e.g., pension and health benefits) would create an appearance of unfairness and may cause resentment among workers in the for-profit sector. On the other hand, employees of NPOs should not suffer the double disability of working for a lower wage and being excluded from basic employee benefit programs provided for other employees in the society.

VIII. Tax Administration Rules.

⁸³ See *CEE Tax Survey*, supra note 16.

⁸⁴ For example, donations of up to _ 3999 are exempt from gift taxes in the Netherlands and donations in excess of that amount are subject to tax at a preferential 11% rate. See Ineke Koele, *Tax Benefits for Public Benefit Civil Society Organizations in the Netherlands*, in Ambrosianeum Foundation, GOVERNANCE AND TAXATION OF PUBLIC BENEFIT NON-PROFIT ORGANIZATIONS (Milan, 2002). For a discussion of similar, but by no means uniform, transfer tax exemption practices in Central and Eastern Europe, see *CEE Tax Survey*, supra note 16.

⁸⁵ In Australia, however, NPOs involved in social welfare work pay reduced sales taxes and, if their payroll is over A\$10,000 a month, a reduced payroll tax as well, depending on which State they are in.

In countries around world the tax rules and preferences that apply to NPOs and their donors are generally applied by the tax authorities. There may be different authorities to handle different taxes, such as the income tax, VAT, customs duties, and real property taxes. In many countries, each tax authority develops its own rules and procedures and may define basic terms, such as “public benefit organization,” differently.⁸⁶

In many developed countries with sophisticated tax systems and large NPO sectors, there may be separate forms, rules, and procedures for NPOs, tailored to the unique characteristics of various kinds of NPOs.⁸⁷ For example, there may be special rules for PBOs, which are treated more favorably than other NPOs. Some countries have developed separate accounting rules and standards for NPOs,⁸⁸ and some tax authorities have separate units to deal with NPOs.⁸⁹ In many countries, however, NPOs must file and report using the forms and procedures designed for business entities, and tax officials with little understanding of, or sympathy with, NPOs often apply the tax rules to them.⁹⁰

Like other laws, tax laws are no better than they way they are administered, and in most countries much work needs to be done to make the rules, procedures, and forms that apply to NPOs suitable to their special characteristics and to ensure that the rules and procedures are applied effectively and fairly.

⁸⁶ It is also common to have special rules that apply to public fund-raising by PBOs. These tend not to be tax rules but rather are administered by authorities that deal with public protection, such as the office of the State Attorney. In some countries, e.g., the Netherlands, these rules are administered by a self-regulatory body and not by the government. See the website of the Central Bureau of Fundraising at www.cbf.nl/.

⁸⁷ This is true in the three countries discussed in the U.S., the U.K., and Germany.

⁸⁸ E.g., Switzerland and the United States. A description of the newly developed accounting rules for NPOs in Switzerland can be found in the October 2003 issue of the INTERNATIONAL JOURNAL OF CIVIL SOCIETY LAW, available at www.law.cua.edu/students/orgs/IJCSL/.

⁸⁹ One of the reasons that the tax laws affecting NPOs in the United States have been designed and applied in a way that is supportive of NPOs is that they are administered by a separate unit of the Internal Revenue Service that is dedicated to tax exempt organizations and whose employees devote their careers to handling the tax affairs of NPOs, giving them both great expertise and a supportive rather than a revenue collector’s attitude towards the sector.

⁹⁰ For example, the Polish tax authorities recently sought to tax the Polish Science Foundation on its entire endowment on the ground that a Polish foundation is exempt only if it spends its money on good works not if it uses the money to buy stocks and bonds. The Foundation had to take the case to the Supreme Court of Poland to get this position, which was based on a fundamental failure to understand the nature of a grant-making foundation, overturned. See discussion of the Polish Foundation of Science case in the April 2003 of the INTERNATIONAL JOURNAL OF CIVIL SOCIETY LAW, available at www.law.cua.edu/students/orgs/IJCSL/.

IX. Administration of Tax Preferences by a Public Benefit Commission.

In many countries the determination of whether an NPO qualifies as a PBO is made by a Public Benefit Commission (PBC) which is established as an independent administrative body composed of representatives of the government, the PBO community, and the public. The Model for a PBC is the Charity Commission of England and Wales,⁹¹ which has been in operation for many years. Developments in other countries such as Brazil, Italy, Moldova, Russia, and, most recently, in New Zealand and Scotland indicate the growing acceptance of PBCs around the world.

A PBC acts as the certification, oversight, and sanctioning authority for PBOs. A key benefit of unifying these various responsibilities in a specialized commission is the quality as well as consistency of decision-making that is brought to the process by commissioners who are experts on PBOs. The PBC should receive an annual budget appropriation necessary for the fulfillment of its duties, and it should be able to hire expert staff to carry out its role as PBO regulator.

Other entities that may serve as the certification authority for PBOs in various countries include (1) courts, (2) line ministries, each within its area of expertise (e.g., health, education, sport), (3) one specific ministry (e.g., Justice or Finance or Civil Affairs). Either (1) line ministries or (2) one specific ministry could exercise the oversight authority of PBOs. However, none of these options provides the efficiency or consistency and quality of decisions provided by a specialized commission.

The administrative law of any country will, of course, regulate the establishment and operations of a PBC. Many essential features of the Commission are not addressed in the Model Provisions set out in Appendix H, because different solutions will be appropriate for different countries. For example, a specific PBC size needs to be stipulated. In general, the PBC should be of medium size (perhaps between six (6) and twelve (12) Commissioners), allowing for both broad representation of interests and efficiency.

Also, the specific composition of the PBC, terms of service of Commissioners, and the process through which they are selected are not specified in the Model Provisions. Again, this is because there are many possible solutions; the one most appropriate for a particular country should be selected and included in that country's PBO law.

⁹¹ See the Charity Commission website at www.charity-commission.gov.uk for a description of the Commission's organizational structure and duties.

An interesting approach to the size and composition of a PBC is presented in the Moldovan Law on Associations (1996/97). The Moldovan Commission consists of nine (9) persons, of whom three (3) are appointed by the President, three (3) by the Parliament and three (3) by the Government. At least one of each of the three sets of three (3) appointed members must be a representative of a PBO and must not simultaneously be a civil servant, a government official, or a Member of Parliament.

Under other approaches (e.g., in England and Wales) there is no parliamentary representation on the PBC, but instead there would be an equal number of government and PBO representatives. Whatever approach is used, however, there should be PBO representation, either through an appointive process or by selection through a democratic process administered by the PBO community. The presence of PBO representatives protects against repressive or discriminatory decisions and increases the confidence of the public. It is clear, however, that selection processes for the PBO representatives must be fairly determined so that adequate representation of interests is assured over time.

In addition, the length of terms for the Commissioners serving on the PBC should generally be between two (2) and six (6) years. The term should be long enough to assure experience on the PBC, but short enough to prevent stagnation or entrenchment of interests. To ensure continuity, terms should be staggered. It may be appropriate to put limits on how many consecutive terms may be served by an individual.

Finally, there is a model of self-regulation being developed in two countries that pairs the PBC idea with delegation by the government of PBO certification to a non-governmental agency. In the Philippines, for example, the Philippines Council for NGO Certification oversees the granting of tax preferences for PBOs. It was established by six NPO networks, and it has an agreement with the Department of Finance to oversee the PBOs.⁹² A more recent model can be found in Pakistan, where the Pakistan Centre for Philanthropy – an NPO -- has a similar arrangement with the tax authorities in that country.⁹³

Conclusion. This part of the paper has provided an overview of the tax rules that various countries provide for the benefit of NPOs. Selected with care and administered judiciously, tax rules for NPOs can further important activities that the

⁹² For more information on the PCNC, see www.pcnc.com.ph.

⁹³ For more information, see www.pcp.org.pk/certification.htm.

state wishes to support and encourage. As can be seen from the overview, however, the tax preference systems are not uniform, and each country must make its own decisions about which tax rules are most suitable for it by taking into account the specific economic, social, and political realities it confronts.

Appendix A

DEDUCTIONS, CREDITS, AND RECLAIMS COMPARED

Deductions

TAXABLE INCOME	TAX RATE	TAX	GOV=T LOSES	CHARITY RECEIVES
100,000	40%	40,000		-0-
<u>5,000</u> = charity				
95,000	40%	38,000	2,000 (5%)	5,000
50,000	20%	10,000		-0-
<u>5,000</u> = charity				
45,000	20%	9,000	1,000 (10%)	5,000
25,000	10%	2,500		-0-
<u>5,000</u> = charity				
20,000	10%	2,000	500 (20%)	5,000

Credit

TP contributes 5,000 to charity; assume a 50% credit.

$5,000 \times 50\% = 2,500$ tax reduction regardless of tax rate.

Charity receives 5,000, the same as in each deduction example above.

The 2,500 credit equals a 6.25% tax reduction for the taxpayer in the 40% bracket, a 25% tax reduction for the taxpayer in the 20% bracket, and a 100% tax reduction for the taxpayer in the 10% bracket.

Tax Reclaim Compared to Deduction

Assume: TP=s goal is for charity to receive 1,000. Tax rate = 28%.

1) Deduction:

TP gives , 1,000 = charity and deducts , 1,000 from taxable income.

TP pays , 280 less in taxes (1,000 x 28%)

2) Reclaim:

TP gives , 780 = charity.

TP gets no tax reduction for this contribution.

TP pays , 220 in taxes on the , 780 contribution to charity (780 x .28 = 220 (rounded)).

Charity Areclaims@ from Inland Revenue the , 220 tax TP paid on , 780.

Charity receives: , 780 from TP + , 220 from Inland Revenue = , 1,000.

Inland Revenue gives up , 60 less (, 220 instead of , 280).

TP pays lower taxes in the case of a deduction than in the case of a reclaim: the deduction reduces taxes by , 280 (, 1,000 x .28 = , 280)

In the case of the reclaim, TP must pay full taxes on the contribution: , 780 x .28 = , 220 (rounded).

In each case, TP is , 1,000 out of pocket:

Deduction: , 1,000 contribution but no tax on it.

Reclaim: , 780 contribution + , 220 in tax on that amount = , 1,000

Benefits to government of reclaim system: (1) smaller revenue loss, (2) less fraud, and (3) the Afloat@ on taxes paid on contribution between the time received and the time the reclaim amount is paid.