CHINA'S TAX RULES
FOR NOT-FOR-PROFIT ORGANIZATIONS

A Study Prepared for the World Bank

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Foreword

This report on *China's Tax Rules for Not-For-Profit Organizations* is a consultants' report to the World Bank and for submission to the Ministry of Civil Affairs. Not for Profit Organizations (NPOs) in China are rapidly growing in China, and the government is keen to develop its potential as public service delivery agents of tasks currently still performed predominantly by government. In addition, NPOs can form the backbone of a lively civil society that has proven to be important for growth and development in other countries. NPOs in many countries around the world further public goals that are supported and often produced by the government, such as health care, education, and social assistance. Because of the public benefit of NPOs, many countries therefore have special tax rules for such NPOs, apart from on occasion supporting their activities directly from the budget. This report discussed the possibilities for such special tax rules for NPOs, and we hope that this report will contribute to the ongoing debate in China on this important topic.

While the World Bank agrees with many of the observations and recommendations made in the report, we prefer at this stage not to issue it as a formal World Bank report. The main reason for this is that we believe that the recommendations are more a set of options for China to consider rather than the ones that China must follow at this stage.

Of particular importance in considering the implementation of the recommendations is the administrative capacity within China, and within the Ministry of Civil Affairs and the State Tax Administration in particular. We feel that a thorough assessment of the needed implementation capacity in these and other agencies needs to be done before more firm recommendations can be made for China.

In addition, we believe that the granting of any tax benefit should be assessed against any of the competing goals of government spending. This should be done as part of a careful policy and budget debate, which we believe is yet to take place. For this reason, it would be most helpful, if for any of the recommendations made in the consultants' report the budgetary implications were to become clear. These budgetary implications would then become a basis for deciding on the proposed policy, and on feasible phasing of implementation of the recommendation. Such estimates were clearly beyond the mandate of the consultants, and we recommend the authorities to do such an assessment as soon as possible.

We believe that the priority of China's policy makers should go to reforming the treatment of donations in income tax. We fully endorse the report's recommendation that donations to public benefit NPOs should get favorable treatment in personal or enterprise income tax (possibly up to a maximum), and should not be taxed as income of the beneficiary NPO under the enterprise income tax. How much favorable treatments, and what limits on individual deductions for such purposes should be granted is again to be debated among China's decision makers.

Critical for any recommendation is a credible administration for accrediting NPOs as being "public benefit organization (PBO)." Given the tax benefits that could accompany such a status, it is key that such be done with the utmost care, and based on clear policy decision, possibly by law. Moreover, in this it should not just be the intent of the NPO that counts, but also the capacity of the NPO to deliver in its pursuit of public benefits. Setting up an administration that is capable of doing such accreditation is no easy feat, and deserves due attention in the debate.

We note here that good administration should be accompanied by clear legal sanctions for those that abuse PBO status, similar to the ones applied for comparable infringements against the tax laws of China. Such sanctions should be part of any policy package that aims at granting NPOs special tax status.

The report recommends a range of taxes for which PBOs could be exempted. While we recognize that in various countries around the world show the variety of tax exemptions mentioned, we feel that these should be seen as a menu of options for China's authorities to consider.

Nevertheless, we feel that the report is a very valuable contribution to the debate in China, with a wealth of relevant international experience in this important field. We would be very interested in discussing the report with stakeholders in China.

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The study was carried out under the overall guidance of the Ministry of Civil Affairs. Deputy Director-General Li Yong of MoCA's Department of NGO Administration provided valuable advice and inputs throughout the study. Division Chief Wang Wen of the MoCA Division of Social Organizations Administration coordinated the implementation of the study. Yu Yonglong, from the same division, served as the MoCA contact person and organized the two review seminars in Beijing and Shenzhen.

The project team did extensive research and undertook a wide range of consultations during the preparation of the report. At the early stage of the study, the China NPO Network headed by Shang Yusheng helped organize three meetings for the consultant to collect information and views on the subject from representatives of three different types of Chinese NPOs, i.e. social organizations, private non-enterprise units and foundation. The outlines of the report were presented and discussed at a NPO Law Forum organized by the Research Center for the Law of NPOs of Beijing University. A draft version of the report was presented for discussion at two seminars organized by the MoCA in late May in Beijing and Shenzhen. Many participating government officials, academics, and NPO practioners made useful comments at those seminars. Deepak Bhattasali and Bert Hofman provided important advice and guidance to the study. Several experts inside and outside the Bank, including Tuan Minh Le, Chunlin Zhang and Andrew Watson (Ford Foundation), reviewed the draft version of the report and gave useful comments,.

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Executive Summary

The State Administration of Taxation (SAT) announced in early 2004 that the tax system in China would be undergoing a significant overhaul during this year. Consistent with that process, at the request of the Ministry of Civil Affairs (MOCA) , the World Bank organized and funded this study, the aim of which is to provide a thorough look at the tax system applicable to the not-for-profit sector in China and to make recommendations for changes in that system. The Ministry of Finance (MOF) and the SAT were supportive of the proposed study. The report has been prepared by three consultants to the World Bank and represents their views. Although the World Bank agrees with many of the observations and recommendations made, the report should not be considered as World Bank policy advice at this stage.

China's not-for-profit sector consists of social organizations (SOs) (*shehui tuanti),* foundations (*jijinhui),* and private non-enterprise units (PNUs) (*minban fei qiye danwei.)* In the Report these three types of organization are collectively called not-for-profit organizations or NPOs. The Report recognizes that many of the tax rules applicable to such organizations also apply to public institutions (*shiye danwei*) and that many *shiye danwei* are in the process of becoming NPOs. Those organizations are not discussed in detail in the Report, however, because they are not currently non-governmental NPOs organizations and many of the legal rules applicable to them are quite specialized.

The first part of the Report (authored by Dr. Jin Dongsheng) discusses the development of the different types of NPOs in China and what each of them does. Secondly, it describes in detail thirteen different taxes in China and the way they do or do not apply to NPOs. It also considers the rules applicable to donations to NPOs under the tax laws and the Public Benefit Donations Law and the application of the current tax administration system to NPOs.

The second part of the Report (authored by Dr. Leon Irish and Prof. Karla Simon) considers the tax laws applicable to NPOs in other countries around the world. It is organized in a manner similar to Part I, looking at the different kinds of taxes, as well as the rules for donations and various administrative aspects of a tax system applicable to NPOs. This section highlights alternative solutions used in different countries – for example, the different kinds of tests used to determine the taxability of income from business activities and the different types of tax preferences available for donations to public benefit organizations. Part II includes numerous references to additional materials that might be consulted by experts as they consider alternatives to the rules contained in the current tax system for NPOs in China. Various appendices provide further detail on how the tax laws of other countries apply to NPOs.

The third part of the Report includes five Principles according to which any reforms of the current system should be made. These are the following:

1. <u>Differentiate Between For-Profit Entities and NPOs</u> -- Existing Chinese non-governmental organizations should be classified into profit-making entities and not-for-profit-making entities; only real NPOs – those that do not have profit-making as their principal goal and that do not distribute profits -- should be permitted to be registered as NPOs.

2. Differentiate Between PBOs and Other NPOs -- NPOs should be divided into public benefit NPOs (PBOs) and regular NPOs (non-PBOs); this will require that the law or regulations be amended to provide a definition of “public benefit.”

3. Implement Fair and Effective Regulation -- NPOs’ activities must be effectively and fairly regulated in accordance with relevant laws and regulations so that they do not take advantage of any tax preferences made available to them.

4. Stricter Regulation for PBOs -- The regulation of NPOs should be proportional to the benefits they receive, which means that PBOs should be regulated more strictly than other NPOs because they should receive greater tax benefits.

5. Principle of Legality -- Similarly situated entities (e.g., all PBOs) should be treated the same, and differently situated entities (e.g., NPOs and PBOs) should be treated differently. All persons of a particular kind (e.g., enterprises or natural persons) receiving tax preferences for donations should be treated the same.

In addition to these five principles, the Report sets forth a number of specific recommendations for improvements in the current tax system applicable to China’s NPOs. The most salient feature of the Principles and the Recommendations is that they advocate the adoption of the concept of “public benefit organization” or “PBO” as well as a set of rules for differentiating between NPOs and PBOs. Only the latter type of organization would be entitled to the highest level of tax benefits.

Substantive Recommendations

1. Definition of NPO -- MOCA, MOF, and SAT should develop rules and regulations clarifying that an NPO is (1) a self-governing legal person (2) that is not 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.

2. Definition of PBO -- MOCA, MOF, and SAT should develop rules and regulations clarifying that a PBO is (1) an NPO that (2) is organized and operated exclusively for public benefit purposes by (3) engaging in public benefit activities that (4) benefit (a) all members of the community or (b) some particular group that is disadvantaged or otherwise deserving of special benefits. Appendix H, setting forth the Model Provisions for Laws Affecting PBOs, contains a useful and proven set of rules for making the differentiation between PBOs and other NPOs.

3. Definition of Public Benefit Activities -- -- In light of Chinese traditions and current needs and priorities, China should carefully define as "public benefit activities" those types of activities that the State regards as having the highest value for society when carried out by the collective action of citizens.

4. Enterprise Income Tax -- NPOs and PBOs should be exempt from the Enterprise Income Tax (EIT) according to the following rules:

   PBOs

- should be exempt from EIT on all their net profits from gifts, grants, and membership dues;
- should be exempt from EIT on all their income from investments (i.e., dividends, interest, rents, royalties, and capital gains);
- should be exempt from EIT on all their income from related business activities; and
- should be subject to EIT on net profits from unrelated business activities.

NPOs

- should be exempt from EIT on all their income from gifts, grants, and membership dues; and
- should be subject to EIT on their net profits from all other sources.

5. Distinguish Between Related and Unrelated Business Activities -- MOCA, MOF, and SAT should develop rules and regulations for distinguishing between related and unrelated business activities of PBOs. Part II and Appendix F on business activities of PBOs will be particularly helpful here.

6. Business Tax and Value Added Tax -- PBOs should be exempted from Business Tax. Rebate for VAT should be provided for PBOs. No exemption nor rebate should be provided for NPOs that are not PBOs.

7. Customs Duties and Import VAT -- All PBOs should be allowed exemption from customs duties and import value added tax (VAT) on goods imported for use or consumption in connection with their public benefit activities. No exemption should be allowed for goods imported by NPOs that are not PBOs or for the non public benefit activities of PBOs.

8. Real Estate Tax -- All PBOs should be exempt from the Real Estate Tax (RET); NPOs should pay one-half of the RPT that would otherwise be due. All real property of both PBOs and NPOs that is used for profit-making purposes, such as rentals, should be fully subject to the RET.

9. Vehicle and Vessel Usage Tax -- All PBOs should be exempt from these taxes; NPOs should pay one-half of the taxes that would otherwise be due.

10. Farm Land Occupation Tax -- There should be no exemption from this tax for any NPOs, not even PBOs.

11. Urban and Township Land Usage Tax and Deed Tax -- All PBOs should be exempt from these taxes; NPOs should pay one-half of the taxes that would otherwise be due.

12. Stamp Tax – There should be no exemption from this tax for any NPOs, not even PBOs.

13. Limitation on Business Activities -- The law and the rules adopted by MOCA, MOF, and SAT should make it clear that a PBO must be devoted exclusively to one or more public benefit purposes and unrelated activities, including unrelated business activities, may not constitute more than an insubstantial part of the activities of the PBO; and that there can be no direct or indirect distribution of profits to anyone at any time, including at termination.

14. Uniformity of Tax Preferences for Donations -- The percentage limitations for donations made by domestic and foreign enterprises should be made uniform. Thus, under the Income Tax for Foreign-funded and Foreign Enterprises, foreign enterprises should be subject to the same percentage limitation on public benefit donations that apply to domestic enterprises under the EIT.

15. Amount of Tax Preferences for Donations -- Tax preferences for deductions should be limited to donations to PBOs, and the percentage limitations on public benefit donations contained in the Individual Income Tax Law and the Provisional Regulations on the Enterprise Income Tax should be increased to:

    - 10% for enterprises (up from 3%) and
    - 50% for individuals (up from 30%).

16. In-Kind Donations -- Deductions for gifts in kind (property) to PBOs should be allowed, but, in the case of property for which there is not a readily ascertainable fair market value, only if the donation is approved in advance by SAT or its branches.

17. Carry Forwards -- Individuals and enterprises should be allowed to carry forward and claim in the next year any charitable contribution deduction that exceeds the annual percentage limitation allowable for the current year.

18. Allow Direct Deductible Contributions -- The tax laws should permit deductible donations to be made directly to all certified PBOs rather than only through certain listed organizations, as is currently the case.

19. Adopt a Tax Designation Scheme -- A "tax designation scheme" should be developed under which, in addition to allowing deductions for contributions to PBOs, an individual would be allowed to designate that 1-2% of his taxes be paid over by the SAT to a PBO designated by him. Development of this scheme will take time, but a decision to adopt such a scheme could be made now.

Procedural Recommendations

20. Receipt for Donations -- A special form of receipt should be designed by SAT to be used specifically for donations to PBOs. An individual or an enterprise should not be allowed to take a deduction for a donation unless the individual or the enterprise has a receipt issued by the PBO to verify the contribution.

21. NPO and PBO Tax Forms -- Special tax forms tailored to meet the needs and special characteristics of NPOs and PBOs should be designed by SAT for both registration and tax filings. Developing the new forms will take time, but work on them could begin now.

22. NPO Accounting Standards -- A new financial accounting system tailored to meet the needs and special characteristics of NPOs and PBOs should be developed[1].

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[1] When this report was being completed, a new *Accounting System for Private Non-Profit Organizations* went into effect on January 1, 2005.

23. <u>Rules for Record-Keeping and Retention</u> -- Record-keeping and record retention rules should be adopted for NPOs and PBOs.

24. <u>Annual Reports</u> -- Annual financial and activity reports should be required for all but the smallest of PBOs; independent certified audits should be required for large PBOs. NPOs and PBOs with income above a specified threshold should be required to file reports at least annually with the tax authorities.

25. <u>Public Reports</u> -- Every PBO that is required to file an annual report with SAT should be required to make that report public. Confidential information and trade secrets may be omitted from the public report. Reports by NPOs do not need to be made public.

26. <u>Governance</u> -- Strong fiduciary duty, conflict of interest, and self-dealing rules should be adopted for both NPOs and PBOs. Good examples of such rules can be found in Appendix H., setting forth the Model Provisions for Laws Affecting PBOs.

27. <u>Code of Conduct</u> -- In order to acquire and retain status as a PBO, an organization must agree to and follow all of the terms, conditions, and procedures of a Code of Conduct to be drafted by PBOs and enforced by the PBC.

28. <u>Compensation Limits</u> -- Compensation limits should be imposed on PBOs, by requiring them to adopt a salary scale no greater than that of universities or of the government.

29. <u>Registration</u> -- The formalities for tax registration should be simplified for NPOs.

    - Tax registration for NPOs that are not PBOs should be carried out under a simplified procedure.

    - Tax registration for PBOs should require additional scrutiny by SAT and its branches of their proposed purposes and activities, but the procedure should be structured so as not to impose unnecessary burdens.

30. <u>Oversight</u> -- Procedures for the oversight by SAT and its branches of PBOs with special tax preferences should be strengthened.

31. <u>Sanctions</u> -- Special administrative sanctions should be imposed on PBOs that violate the new rules dealing with their records, reports, activities, etc.

32. <u>Public Benefit Commission (PBC)</u> – A PBC should be created, with representatives from MOCA, MOF, SAT, PBOs, and the public. It should be responsible for registration, oversight, and regulation of PBOs. Appendix H, setting forth Model Provisions for Laws Affecting PBOs, contains many of the rules, principles, and procedures that should govern a PBC.

    - The PBC should be established as an autonomous organ of the government.

    - The PBC should have the power and responsibility to certify PBOs; to exercise oversight of PBOs; to apply administrative sanctions to PBOs that violate their duties as established by law or their charters; and to de-certify PBOs when appropriate.

    - The PBC and MOCA should maintain a website with a list of all certified PBOs. This website should be kept up to date on a weekly basis. In addition, the PBC should publish a hardcopy list of certified PBOs at least annually

- Consistent with conferring these powers and responsibilities on the PBC and the development of an expert staff at the PBC, the role of the competent business units (CBUs) in the establishment, oversight, and management of PBOs should be reduced or eliminated.

Development of a PBC will take time, but the publication of a list of certified PBOs should be initiated as soon as possible.

Part III contains a detailed explanation of each of these recommendations, setting forth a rationale, often with references to other parts of the Report and the Appendices. As stated above, the salient feature of the Principles and the Recommendations is that they advocate the adoption of the concept of "public benefit organization" or "PBO" as well as a set of rules for differentiating between NPOs and PBOs. Only PBOs would be entitled to the highest level of tax benefits.

The Procedural Recommendations also suggest the creation of a Public Benefit Commission (PBC), which would become the principal government organ to certify and regulate PBOs. The theory for creating such an entity is that it would become an expert institution that could administer consistently a broad system of tax preferences for PBOs efficiently, fairly, and with input from the public and the PBO sector. Naturally the decision of how to create a PBC will require careful study, but it is consistent with the government's efforts to streamline government operations because developing a PBC and reducing or eliminating the role of CBUs would simplify the process of government oversight and regulation of PBOs and make it more effective.

The Report also contains several appendices, which discuss the tax rules applicable to NPOs in China, in a variety of developed countries (England, France, Germany, Japan, UK, and US), and in as well as transition and developing countries (countries of the former Soviet Union and South Africa). One appendix explains different approaches to the business income of NPOs and another illustrates the effect of different kinds of tax preferences for donations. Appendix H contains the 'Model Provisions' for Laws Affecting PBOs" that were developed by NPO experts in Central and Eastern Europe. The Model Provisions provide a useful guide for developing the rules in China applicable to PBOs as well as the potential creation of a PBC.

This Report contains a great deal of information – both academic and practical -- which supports the recommendations made. Decisions about whether to make or initiate any of these reforms could be made as part of the fundamental reform of the tax system that is currently underway in China. A number of the recommendations will take a time to accomplish fully, but decisions could be made now to begin the reform process.

A draft version of the Report was presented for discussion at two seminars held in late May in Beijing and Shenzhen. Many highly useful comments were made at those seminars by government officials, academics, and NPO practitioners, and the final Report reflects those comments. It was agreed by all who attended the seminars that significant revisions of the current tax system in China are needed to help the NPO sector to develop and mature so that it can better meet the needs of the Chinese people. There should, of course, be further debate and discussion of the recommendations made in the Report, but they present a useful starting point for discussion and decision-making with respect to the tax laws and policies affecting NPOs in China.

Introduction and Overview

The State Administration of Taxation (SAT) announced in early 2004 that the tax system in China would be subject to a thorough-going review this year. Consistent with that process, at the request of the Ministry of Civil Affairs (MOCA) , the World Bank initiated and funded this study, whose aim is to provide an in-depth look at the tax system applicable to the not-for-profit sector in China and to make recommendations for changes in that system. The Ministry of Finance (MOF) and the SAT were supportive of the proposed study.

The Report examines the tax rules that apply to the three different types of Chinese not-for-profit organizations (NPOs): (SOs) (*shehui tuanti),* foundations (*jijinhui),* and private non-enterprise units (PNUs)(*minban fei qiye danwe.)* Although the Report recognizes that many of the tax rules applicable to such organizations are also currently applied to public institutions (*shiye danwei*) and that many *shiye danwei* are in the process of becoming NPOs, those organizations are not discussed in detail in the Report because they are currently not NPOs and many of the legal rules applicable to them are quite specialized.[2]

With the rapid progress of the Chinese economy since the 1980s, NPOs have experienced substantial development. Today they are known as China's "third sector." The absolute number of NPOs and the size of the third sector as part of the gross domestic product are both rapidly increasing. The sector has played a positive role in, and made great contributions to, the economy and to a wide range of important social objectives, including environmental protection, public health, education, science and technology, culture, poverty alleviation, legal assistance, and social welfare. In short, NPOs have become an indispensable component of Chinese society. The tax laws that apply to NPOs, however, do not always serve to further their development and may, to some extent, impede it. The purpose of this Report is to inform the consideration of the current tax laws in China and their impact on NPOs and make recommendations for future reforms of the tax laws so that they may be more supportive of the NPO sector.

The first part of the Report describes the existing tax rules in China for NPOs and the problems facing such organizations because of the current structure of the tax system. The second part discusses key tax issues affecting NPOs and describes tax rules that are applied to them in other countries. The third part discusses principles for tax reform and makes recommendations for consideration as part of the major overhaul of the Chinese tax laws that will be undertaken in future years. Various Appendices are provided to give further details about specific countries or issues. It is hoped that the Report will assist MOCA and the tax professionals and policy-makers in China to design tax rules that will support, promote, and encourage the not-for-profit sector in China in the most appropriate and effective way.

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[2] At the present time most social welfare, educational, health, scientific, and cultural activities in China are carried out by not-for-profit governmental institutions (*shiye danwei),* also known as public service units. There are over 1 million such entities. Although this Report does not deal with *shiye danwei* as such, it should be noted that the Government has declared an intention to transform most of these entities into not-for-profit organizations. Accordingly, consideration of appropriate tax rules for NPOs in China should take into consideration the possibility that the Third Sector may be expanded dramatically in the near future.

For the purpose of describing what this paper is about, it is important to begin with a common understanding both of what an NPO is and what sorts of tax rules may be applicable to it. Thus, this overview establishes a few definitions for terms that will be used throughout the Report.

NPOs and PBOs. In legal systems around the world the general rule is that a not-for-profit organization (NPO) is (1) a legal person (2) that is not 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, directly or indirectly, other than for its not-for-profit purposes. For tax and other purposes, most countries distinguish between the larger class of all NPOs and the subset of NPOs known as “public benefit organizations” (PBOs). A PBO is usually defined as (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 in virtually every legal system.

Tax rules applicable to NPOs. There are several different kinds of taxes from which NPOs may be exempt or be subject to a preferential rate structure: income and profits taxes, real and personal property taxes, wealth transfer taxes (e.g., gift and estate taxes), excise taxes, business taxes, value added taxes (VAT), sales taxes, and other types of national and local taxes.[3] With respect to income and profits taxes, exemption often depends upon the kind of income in question as well as the kind of NPO. Thus, nearly all countries exempt all NPOs from income or profits tax on donations, grants, government subsidies, or membership dues. Most countries, however, exempt NPOs on their investment income (i.e., interest, dividends, rent, royalties, or gains on the sale of assets) only if they are PBOs.

Most countries tax ordinary NPOs on their income from commercial activities, either through the profits tax, a business tax, or both. Many countries, however, exempt the net profits of PBOs to the extent that they are used or set aside for their not-for-profit purposes. It is important to permit PBOs to support themselves by conducting income-producing activities, particularly in countries where there is limited private wealth and no strong tradition of charitable giving. China is probably such a country, and most NPOs and public institutions (*shiye danwei*)[4] in China engage in some form of economic activity for their support. Countries differ on whether net profits of a PBO from economic or business activities not directly related to the organization’s principal purpose should be taxed.

Virtually no countries exempt any NPOs from employment or social security taxes, but PBOs frequently are exempted from property taxes and wealth transfer taxes. With respect to VAT, some countries, for example, make some goods and services that are often provided by PBOs exempt, while others will include PBOs in the VAT system but give them a low or zero rating on their outputs.

In addition to providing various tax benefits to NPOs, and especially to PBOs, most countries also allow an income tax benefit – such as a tax deduction or tax credit – with respect to

[3] Part I goes into significant detail with respect to the different taxes in the Chinese system that may be applied to NPOs. These include, for example, the vehicle and vessel usage tax, the urban land usage tax, and the farm land usage tax, in addition to the more common taxes discussed in Part II.

[4] These are sometimes known as public service units or PSUs. See supra, note 1, for a discussion of why these organizations are relevant to the NPO sector.

contributions by individuals or commercial entities to a PBO. Individuals may also be allowed an income tax deduction from, or credits against, wealth transfer taxes for contributions to PBOs. There typically are numerical or percentage limits on tax preferences for contributions to PBOs. Further development of these ideas can be found in Part II.

Part I China's Current Tax Rules for NPOs

With the rapid progress of Chinese economy since the 1980s, NPOs have experienced substantial development in China. The number of NPOs and the size of the NPO sector – which is sometimes referred to as the Third Sector -- have both been rapidly increasing. The sector has played a positive role in, and made great contributions to, the economy, environmental protection, public health, education, science and technology, culture, poverty alleviation, legal assistance, and social welfare. In short, NPOs have become an indispensable component of Chinese society.

Section 1: Overview of Chinese NPOs

The existing incentive policies that promote the development of NPOs are consistent with the current Chinese government's goal of building a prosperous society, and they have undoubtedly contributed substantially to the growth of the sector. Unfortunately, however, NPOs in China are experiencing difficulties and are constrained by a number of negative factors, including the current system of taxation. Favorable tax policies are vital to the healthy development of the NPO sector. Given these circumstances and taking into account the process of Chinese economic and social development at the current time, it is of both theoretical and practical significance to study the variety of existing tax policies related to NPOs. It is also important to propose changes in the tax policy environment and to make recommendations to further encourage and enhance the development of NPOs.

1.1.1 Concept of Chinese NPOs

A not-for-profit organization (NPO) is literally an organization not intended for profit; these organizations are often referred to as non-government organizations (NGOs), the Third Sector, charity organizations, or the independent sector. Despite the long history of NPOs and their increasingly important roles, the term "NPO" does not have a strict or technical definition either in China or in other countries. From the perspective of their functions, many NPOs are intended to compensate to some extent for functional deficiencies of government by providing public goods and pursuing not-for-profit purposes. For example, they are often engaged in charity, science, education, culture, public health, or other socially beneficial activities. From the perspective of their nature, an NPO can be an organization that is either for mutual benefit (MBO) or public benefit (PBO). From the perspective of their role in society, NPOs are the Third Sector, different from, and independent of, the government as well as being different from the business sector or for-profit organizations. Some people gave different definitions to NPOs based on their legal status, funding sources and tax treatment received[5].

[5] "Categorization of NPOs and Rational Selection", Yang Tuan, Research Center for Social Policy, the Chinese Academy of Social Sciences, 2003; "NPOs and tax exemption", Shao Jinrong, Social Science Press 2003; "Definition of the Third Sector in China", Deng Guosheng, NPO Rsearch Institute of Tsinghua University, 2003.

This part of the Report deals with the current taxation of Chinese not-for-profit organizations, using the term "NPO" to apply to all entities that can be considered to be not-for-profit, non-governmental organizations. Based on the realistic situation of China, the NPOs referred to in this part have the following characteristics: they are organizations that are :

- not intended to make a profit and distribute it to owners or others;
- their activities are for public benefit or for the mutual benefit of their members; and
- they are not primarily engaged in business or economic activities.

More specifically, NPOs in China have one of the following three legal forms: social organizations, privately-run non-corporate units, or foundations.

(1) Social organization (shehui tuanti). In accordance with *Administrative Regulations Concerning Registration of Social Organizations*, a social organization is an NPO that is established on a voluntary basis to pursue the common goals of its membership. All its activities are subject to what is set out in its charter. It may take the form of a charity organization, an industrial association, a research institute, an academic society, etc.

(2) Privately-run non-enterprise unit (minban fei qiye danwei). In accordance with *Provisional Administrative Regulations Concerning Registration of Privately-run Non-Enterprise Units*, "privately-run non-enterprise unit" refers to not-for-profit social service organizations that are established with non-state-owned assets mobilized by not-for-profit government institutions, social organizations, social entities, and individual citizens. They include privately-run schools, hospitals, museums, and scientific research institutes.

(3) Foundation (jijinhui). In the *Administrative Regulations of Foundations*, a foundation is defined as a non-government organization that is set up with funds donated by either domestic or overseas organizations or individuals. They typically promote scientific research, cultural education, social welfare, and other social development activities.

There are also some special social organizations that are between an NPO and a for-profit organization in terms of their typology. Many of them would be properly defined as NPOs. These include special social organizations, public benefit organizations in universities, and enterprise legal persons that in reality have the characteristics of an NPO set out below.

1.1.2 Characteristics of Chinese NPOs

The legal forms used for NPOs in these definitions demonstrate the following common characteristics:

- Not-for-profit. Being not-for-profit indicates the establishment of the NPO is not intended for profit-making purposes. An NPO is not barred from conducting profit-generating activities; however, any profit received cannot be distributed. It must be used for the not-for-profit purposes of the NPO.
- Non-governmental. It is not part of the State.

- Being charitable or mutually beneficial. NPOs can be characterized as being of two types – either charitable (public benefit) or mutually beneficial to their membership.
- Independent. The majority of social organizations, privately-run non-corporate units, and foundations are privately funded and all of them are self-governing.
- Volunteers. NPOs are significantly dependent on volunteers, whether as workers or as oversight (board) representatives. The goal of these individuals is not for personal benefit but rather for social benefit to the whole of Chinese society.

China has witnessed rapid development of the NPO sector since the adoption of reforms and the open-door policy. Authoritative estimates indicate that there are now approximately 1900 nationwide and 200,000 local NPOs. They play a unique role in mobilizing and utilizing all sorts of resources and assisting government at different levels with respect to relieving disaster, helping disadvantaged groups, developing social welfare, safeguarding and promoting social fairness and justice, etc. To some extent, Chinese NPOs have generally won understanding, recognition, and support in the society.

Section 2: Management and Income of Chinese NPOs

Stringent regulations have been adopted by the State Council to govern the sources and utilization of NPO income in China, i.e. NPOs must have legal assets and sources of operational income which should be utilized in strict accordance with the regulations. In addition, a stringent administrative system has also been set up to manage daily NPO operations and to provide audit supervision. The dual registration and management system depends on oversight by competent authorities (sometimes referred to as competent business units or CBUs) and MOCA and its branches.

1.2.1 Social organizations (SOs)*(shehui tuanti)*

In accordance with *Administrative Regulations Concerning Registration of Social Organizations*, social organizations must have a legal source of assets that cannot be misappropriated or embezzled by any unit and individual.

Legitimate revenue sources for social organizations include the following:

1) membership fees;
2) activity fees from government;
3) income derived from economic undertakings specified in the charter;
4) donations and sponsorship;
5) interest and other investment yields.

The regulations governing the utilization of their funds are as follows:

1) Business revenues permitted by the charter cannot be distributed among the membership.
2) Donations and sponsorships received must be consistent with the purposes of the organization and must be used in the manner agreed to by the donor or sponsor and the organization. The social organization must report to the competent authority on receiving

and using donations and sponsorship, and relevant information must be disclosed to the public in an appropriate way.

3) Compensation and welfare benefits for full-time personnel of a social organization must be defined with reference to applicable rules and regulations.

There are also definite and strict regulations concerning the founding and daily operations of an SO. The founding of an SO is subject to approval of a competent authority, which is obtained by applying to the registration and administration department of the competent authority. The foundation of social organization must satisfy the following conditions:

1) There must be over 50 individual members or over 30 institutional ones. The total number of members must be no less than 50 where there are both individual and institutional members;
2) The SO must have an appropriate name and organizational structure;
3) The SO must have a permanent place of business;
4) The SO must have personnel qualified to carry out its activities;
5) The SO must have adequate financial resources to carry out its activities. Specifically, a nationwide social organization must have a minimum operational fund of 100,000 yuan, while a local one must have 30,000 yuan;
6) The SO must be able to shoulder civil responsibility.

When a social organization is established it is subject to the financial management system defined by the state and the supervision of the state finance department. It will also be subject to supervision of the audit department if the assets of the social organization are from state allocations or social donations and sponsorship. In accordance with *Administrative Regulations Concerning Registration of Social Organizations*, annual reports describing the activities of the previous year must be submitted to the competent authority for approval before 31st of March of the current year. When approved by the competent authority, the report must be submitted to the registration department for annual examination prior to 31st of May. The annual report includes information of the social organization with respect to its compliance with relevant law and regulations, registration, activities in accordance with its charter, changes in its personnel or, organizational structure, its finances, etc.

1.2.2 Privately-run non-enterprise units (PNUs)*(minban fei qiye danwei)*

In accordance with *Provisional Administrative Regulations Concerning Registration of Privately-run Non-enterprise Unit*s, privately-run non-enterprise units must have one or more legitimate sources of assets and any assets must not be misappropriated or embezzled by any individual or institution.

Legitimate sources of assets for a PNU include the following:

1) Legitimate proceeds derived from activities or services undertaken in accordance with the charter and relevant state regulations;
2) Donations and sponsorships received;
3) Interest and yields from investments.

The legitimate use of the above funds refers to the following:

1) Business activities defined in the charter.
2) Donations and sponsorship received must be consistent with the aim and business scope of the charter and be used as agreed with the donor or sponsor. The PNU must report to the competent authority on receiving and using any donation or sponsorship. Relevant information will be disclosed to the public in an appropriate way.

There are also definite and strict regulations concerning its founding and daily operations of a PNU. The founding of a PNU is subject to the following:

1) It must be approved by the appropriate competent authority;
2) The PNU must have an appropriate name and organizational structure;
3) The PNU must have personnel qualified to carry out the activities stated in its charter.
4) The PNU must have legitimate assets appropriate for carrying out its activities; and
5) The PNU must have a permanent establishment.

After the founding of the unit, it is subject to the dual supervision of both the competent authority and the registration department. The registration department is responsible for: (a) establishment, amendment, and cancellation of registration of PNUs, (b) monitoring and supervision of the operations of PNUs, (c) initial examination of the annual s of PNUs, (d) assisting with the investigation into and punishment of any criminal cases involving PNUs, and (e) supervision of any liquidation of PNUs.

In accordance with *Provisional Administrative Regulations Concerning Registration of Privately-run Non-enterprise Units*, the financial management of a PNU must comply with the financial management system prescribed by the state and supervised by the finance department. Funding from the government or social donations and sponsorships are subject to the supervision of the audit department. In addition, the annual report for each PNU for the previous must be submitted to the competent authority for approval before 31st of March of the current year. When approved by the competent authority, each annual report must be submitted to the registration department for annual examination prior to 31st of May. The annual report must include information with respect to the PNU's compliance with relevant laws and regulations, registration, activities in accordance with its charter, change in its personnel and organizational structure, its finances, etc.

1.2.3 Foundations *(jijinhui)*

According to *Administrative Regulations of Foundation*, a foundation is set up to manage funds donated voluntarily for the promotion of scientific research, cultural education, social welfare, and other beneficial social activities. A foundation is mainly funded by:

1) voluntary donations from either domestic or overseas organizations or individuals;
2) grants or subventions from public sources, and earnings on its endowment, such as interest and dividends from bonds and stocks.

The Administrative Regulations of Foundations stipulate the use of foundation funds as follows:

1) The property of a foundation is protected by law, the funds must be used to finance the activities and undertakings stated in the charter of the foundation, and must not be misused.
2) The funds (endowment) should be held in safe and productive investments.
3) At least 70% of annual earnings on any public funds must be used for public benefit purposes.. An amount equal to at least 80% of any private funds held at the end of the prior year must be used for the public benefit purposes.
4) No more than 10% of any public funds may be used for employees' salary and administrative overhead and expenses.
5) The foundation should announce the kinds of projects it will fund and the process for applying for grants and evaluating applications.
6) The foundation should apply unit accounting system and establish an audit system.

There are strict management rules and regulations governing the establishment and daily operation of foundations. The establishment of a foundation is subject to the following conditions:

1) The establishment of the foundation must be for a particular public benefit purpose;
2) A national public foundation must have a registered endowment of a minimum of 8,000,000 yuan, a local public foundation must have a registered endowment of at least 4,000,000 yuan, and a private foundation must have a registered endowment of at least 2,000,000 yuan. The original funds must be in cash or cash equivalents;
3) Each foundation must have an appropriate charter, organizational structure and qualified financial personnel;
4) Each foundation must have a permanent place of business ;
5) Each foundation must be able to shoulder civil responsibility.

After the establishment of a foundation, it is subject to the dual supervision of both the competent authority and the registration department. The registration department is responsible for: (a) establishment, amendment, and cancellation of registration, (b) monitoring and supervision of the operations of foundations, (c) initial examination of annual reports by foundations, (d) assisting with the investigation into and punishment of any criminal cases involving foundations, and (e) any liquidation of a foundation.

Only after acquiring status as a legal person can a foundation commence it activities. Special procedures govern any change in the name of a foundation or any merger or termination of a foundation. When a domestic or foreign foundation has been established, it must have a tax registration, and it is entitled to any tax benefits provided for foundations by law or regulations.

1.2.4 The income resources of NPOs

The above three types of NPOs in China are allowed to have diversified sources of income, and there are significant differences in the sources they rely on.

1) According to the results of the study undertaken in preparation of this Report, more than

half of the income of social organizations derives from membership fees. Business income constitutes the second largest income source for social organizations, and social donations and project funds are the third. Government allocation and subsidy may be part of SO income as well.

2) Having little government allocation and subsidy, privately-run PNUs mainly rely on business income and receive very little social donation.

3) The sources of income for foundations differ according to the principal sponsor. Foundations that are officially hosted derive their funds mainly from government allocations, subsidies, and social donations. Earnings on their endowments also contribute a large portion of their income. The sources of income of the foundations that are privately sponsored are very limited and principally consist of the original endowment and earnings on it. They receive very few donations.

It is true that funding sources for Chinese NPOs are not standard and balanced. Social organizations and foundations are heavily reliant on government, while privately-run non-corporate units rely on their own substantial profit-generating capacity. Specialists familiar with Chinese NPOs report that social donations do not represent the most significant part of the funding for any of the three types of NPOs. It is also important to note that all three types of Chinese NPOs engage in investment and/or business activities.

Section 3: Existing Tax Laws and Regulations for Chinese NPOs

There are no NPO-specific tax laws or systems in China and the relevant provisions are found among the laws and regulations relating to all taxes. Indeed, NPOs must pay taxes for many activities; but they sometimes enjoy certain tax incentives. This section discusses the relevant tax rules applicable to NPOs in China. The basic revenue source in China today is turnover taxes. Generally, NPOs engaged in social action, would pay all relevant taxes unless they are specifically made exempt.

1.3.1 Enterprise income tax

According to the *Provisional Regulations of the People's Republic of China on Enterprise Income Tax* and the corresponding detailed implementation rules, taxpayers subject to the enterprise income tax include enterprises or organizations that exercise economic accounting – this includes state-owned enterprises, collectively-run enterprises, joint-operational enterprises, stock-holding enterprises, and other organizations that have income from production, operations, and other sources. The aforementioned "other organizations" include legally registered not-for-profit government institutions and social organizations whose establishment is approved by relevant departments. Social organizations and not-for-profit government institutions are apparently taxpayers under the enterprise income tax if they have income from production and operations, i.e. taxable income. Foreign-funded NPOs are subject to the *Income Tax for Foreign-funded and Foreign Enterprises*.

The enterprise income tax covers income derived from: (1) production and operations; (2) transfers of property; (3) interest; (4) leasing; (5) royalties; (6) dividends; and (7) other sources.

The term “other sources” refers to all the sources except the above-mentioned ones, including membership fees and donations.

Deductions generally applicable under the enterprise income tax are also available to NPOs in accordance with the law. These include costs, expenses, and losses associated with the generation of taxable income. Deductions are also available for certain amounts of loan interest, taxable salaries, employee memberships, welfare and education fees, social security contributions by the employer, and expenses associated with the obtaining of donations.

With the standard income tax rate being 33%, there are two preferential rates. The reduced rate of 18% applies to taxable income of less than 30,000 yuan while 27% applies to the taxable income ranging from 30,000 to 100,000 yuan. Many NPOs will have small enough amounts of taxable income to be subject only to these lower rates of tax.

The administrative rules of the tax system that apply to enterprises also apply to NPOs. NPOs must file an annual report with the competent tax authority irrespective of whether any tax is due and payable. Taxes are assessed on a yearly basis but are withheld and paid to the tax authorities on a monthly or quarterly basis, i.e. taxes are withheld within 15 days at the end of the month or the quarter and any remaining balance must be paid within four months after the end of the year, at the time of filing the annual report.

1.3.2 Business tax

According to the *Provisional Regulations of Business Tax* and the detailed implementation rules, taxpayers of business tax are all units and individuals that provide taxable services, transfers of intangibles, or sell real estate within the boundary of the People’s Republic of China. They include all types of enterprises, administrative units, institutions, military units, and social organizations. Therefore, NPOs are payers of the business tax if they are engaged in activities that are taxable under the business tax. The business tax is based on the gross value of services rendered and is equivalent to a value added tax on services. A provider of taxable services collects the tax from the purchaser of the services and can credit against it any business tax the provider paid for taxable services received by the provider.

The following nine kinds of services are subject to the business tax: industries of transport, finance and insurance, post and telecommunications, culture and sports, entertainment, service, transfer of intangibles, and sales of real estate. The rates that apply to these nine categories are 3%, 5%, and 20% respectively. The current threshold for business tax is as follows: turnover of 1000 to 5000 yuan for the tax assessed against business taxpayers with fixed locations, which are assessed by period and 100 yuan for all other taxpayers, which are assessed by time (or day).

1.3.3 Value added tax

According to the *Provisional Regulations of Value Added Tax* and the detailed implementation rules, payers of value added tax (VAT) are all units and individuals that sell goods or provide processing and repairs for goods as well as those that import goods within the boundary of the People’s Republic of China. Those liable for the VAT include all types of enterprises, administrative units, institutions, military units, and social organizations. Therefore, NPOs are payers of value added tax if they are engaged in taxable activities that are subject to that tax.

The VAT base is the value added of taxable goods or processing and repair of goods and is calculated on the basis of gross turnover. The standard VAT rate is 17%, while 13% is the reduced rate. The VAT rebate rates are 5%, 8%, 11%, 13%, and 17% respectively. A simple, easy "convenience collection" method applies to small-scale taxpayers, i.e. the tax rate of 6% applies to small-scale producers of goods while 4% applies to small-scale sellers of goods. The existing VAT thresholds are as follows: monthly sales amount from 2000 to 5000 yuan for producers or sellers of goods and monthly sales amount from 1500 to 3000 yuan for sales of taxable services; turnover from 150 to 200 yuan for the tax assessed time (or day).

1.3.4 Tariffs (customs duties)

According to the *Regulations on Import and Export Tariffs*, consignees of import and consigners of export are payers of tariffs. Therefore, NPOs are tariff payers if they are engaged in import and export activities as defined by tax laws.

At present, the majority of imports are subject to import tariffs, and only a few exports are subject to export tariffs. Tariff rates vary from taxable item to item including rate of most favored nations, tax treaty rate, concessionary rate, and standard rate. The standard rate of 11% was reduced to 10.4% in 2004.

1.3.5 Real Estate Tax

According to the *Provisional Regulations of Real Estate Tax*, this tax is administered in cities, counties, towns, and industrial and mine districts. Payers of real estate tax are owners, managers, mortgagors, or users of real property. Both Chinese and foreign NPOs are real estate taxpayers if they are engaged in the above-mentioned taxable activities.

The real estate tax is assessed annually either on the value of the property or on the rents derived from it. If the former is the case, the tax is levied on the value remaining after a lump sum deduction of 10-30% of the original value of the property and the applicable tax rate is 1.2%. In the case of rental property, the tax rate of 12% applies.

1.3.6. Vehicle and vessel usage tax

According to the *Provisional Regulations of Vehicle and Vessel Usage Tax*, payers of this tax are all units and individuals that possess and use vehicles and vessels in China. Accordingly, NPOs are payers of this tax if they possess and use vehicles and vessels. *Provisional Regulations on Vehicle and Vessel License Plate Usage Tax* applies to foreign funded enterprises.

This tax is assessed annually and paid quarterly. The tax rate is based on the deadweight tonnage of cargo carrying vehicles and vessels, i.e. deadweight tonnage of cargo motor vehicles and the tonnage of other types of vehicles.

1.3.7. Urban land usage tax

According to the *Provisional Regulations of Urban Land Usage Tax*, all units and individuals that use land in cities, counties, towns, or industrial and mine districts are payers of this tax.

Although domestic NPOs are apparently subject to this tax, foreign-funded NPOs are not subject to these provisional regulations, and instead pay a fee for using the land.

Assessed annually, this tax is based on the area occupied by the taxpayer and paid according to a prescribed amount. The amount for every square meter is decided by local government within the following parameters:

- 0.5-10 yuan in big cities
- 0.4-8 yuan in medium-sized cities;
- 0.3-6 yuan in small cities;
- 0.2-4 yuan in towns and industrial and mine districts.

1.3.8 Land value added tax

According to *Provisional Regulations of Land Value Added Tax*, taxpayers of this tax are all units and individuals, including NPOs, that sell land, buildings, or the right to use state-owned land.

Four progressive tax rates apply to the value added in excess of the deductible amount as follow:

- 30% for value added less than 50% of the deductibles;
- 40% for value added between 50% and 100% of the deductibles;
- 50% for value added between 100% and 200%of the deductibles;
- 60% for value added over 200% of the deductibles.

1.3.9 Farm land occupation tax

According to the *Provisional Regulations on Farm Land Occupation Tax*, all units and individuals that occupy or use farm land for non-agricultural purposes must pay the Farm Land Occupation Tax. Foreign enterprises, joint ventures with foreign investment and foreign individuals do not need to pay the Farm Land Occupation Tax. The Farm Land Occupation Tax is computed based on the area of the farm land actually occupied and applying the specific applicable rate of tax. It is paid annually in a lump sum.

1.3.10 Deed tax

According to the *Provisional Regulations on Deed Tax*, all units and individuals that are the transferees of rights to and ownership in land and/or buildings transferred within the territory of China are subject to the Deed Tax. The “units” mentioned here refer to enterprises, government institutions, governmental organs, military units, social organizations, and other organizations, including NPOs.

The “transfer of right and ownership of land and buildings” mentioned in the tax law refers to the following acts: (1) the transfer of the usage rights to State-owned land; (2) the transfer of the usage rights to privately owned land, including sale, donation, and exchange; (3) sale and purchase of buildings; (4) donation of buildings; and (5) exchange of buildings. The tax rates for the Deed Tax range from 3% to 5% of the value of the rights or property transferred. The specific rates applicable in jurisdictions at the provincial level are determined by the people's governments of the provinces, autonomous regions, and municipalities within the above-mentioned range based on the needs and conditions of the jurisdictions.

1.3.11 Vehicle acquisition tax

According to the *Provisional Regulations on Vehicle Acquisition Tax*, all units and individuals that acquire taxable vehicles within China are subject to the Vehicle Acquisition Tax. The "units" mentioned here refer to State-owned enterprises, collectively-owned enterprises, privately-owned enterprises, joint-stock enterprises, enterprises with foreign investment, foreign enterprises, and other enterprises, as well as government institutions, social organizations, governmental organs, military units, and other units.

The NPOs that acquire taxable vehicles are subject to the tax in accordance with the tax law. Vehicles that are subject to Vehicle Acquisition Tax include motor vehicles, motorcycles, trams, trailers, farm transportation vehicles, etc. The Vehicle Acquisition Tax is imposed in connection with each successive acquisition of a taxable vehicle and the applicable rate for is 10% of the taxable price of taxable vehicle.

1.3.12 City maintenance and construction tax

According to the *Provisional Regulations on City Maintenance and Construction Tax*, the City Maintenance and Construction Tax is based on the amount of any turnover tax paid and is in addition to it. All domestic enterprises or units that are liable for turnover taxes, including Chinese NPOs, are subject to the City Maintenance and Construction Tax. However, any NPO, foreign or Chinese that is foreign funded, is not subject to City Maintenance and Construction Tax.

According to the provisions on the City Maintenance and Construction Tax, three tax rates, namely, 1%, 5%, and 7%, are adopted in line with the different sizes of the cities. Any reduction in, or exemption from, any turnover tax will also be a reduction or exemption with respect to the City Maintenance and Construction Tax.

1.3.13 Stamp tax

According to the *Provisional Regulations on Stamp Tax*, all units and individuals that either execute or receive documents are subject to the Stamp tax. Taxable documents include: (1) contracts or documents in the nature of a contract with regard to purchases and sales, the undertaking of processing, contracting for construction projects, property leasing, commodity transport, warehousing, loans, property insurance, and technology contracts; (2) documents transferring property rights; (3) business account books; (4) certificates evidencing rights or licenses; and (5) other documents which the Ministry of Finance determines to be taxable.

According to the *Provisional Regulations on Stamp Tax*, the applicable tax rate is from 0.5% to 1, or 5 yuan for each accounting book, permit certificate, or business document. NPOs are like other taxpayers with respect to collection and compliance with the "Tax Collection and Administration Law" and the corresponding detailed rules for implementation with respect to each of these taxes. Certain exceptions applicable to NPOs and not specified above are discussed below.

Section 4: Preferential Tax Policies in China for NPOs

Based on the research and analysis done for this Report, China's preferential tax policies for NPOs are classified into three categories, namely, preferential tax policies for NPOs, preferential tax policies for enterprises that make donations to the NPOs, and preferential tax policies for individuals that make donations to NPOs.

1.4.1 The preferential tax policies for NPOs

A variety of preferential tax policies that cover almost all the taxes that are levied on NPOs have been stipulated in the tax laws and regulations of China.

1.4.1.1 Enterprise income tax

According to the *Measures for the Collection and Administration of Enterprise Income Tax for Government Institutions, Social Organizations and Privately-run Non-corporate Units* and other related tax laws and regulations, some items of NPOs income enjoy tax exemption.[6]

In addition, as far as not-for-profit scientific research institutions are concerned, it is stipulated in the tax laws that the income derived by not-for-profit scientific research institutions from their technology development, technology transfer, and the related technology advisory services are exempt from Enterprise Income Tax in accordance with

[6] The tax-exempt items are as follows:
(1) Financial appropriations to NPOs;
(2) Governmental grants or subventions that are set and received by NPOs with the approval of the State Council and the Ministry of Finance, so long as they are taken under fiscal budget administration or under special administration of off-budget funds;
(3) State funds used to pay the administrative operating expenses of NPOs that are approved by the State Council or the People's governments at the provincial level (excluding the cities that are listed separately under the State Budgetary Plan) and are taken under fiscal budget administration or under special administration of off-budget funds;
(4) Off-budget funds that are approved by the Ministry of Finance and are not taken under special financial administration;
(5) Earmarked subsidies received by government institutions from the authorities in charge of them and authorities superior to them for the development of their undertakings;
(6) Income derived by government institutions from the after-tax profits of the business operating unit that is in charge of them and conducts independent accounting;
(7) Financial aid received by social organizations from governments at different levels;
(8) Membership fees charged by social organizations in accordance with the rules and regulations stipulated by the civil and financial departments above the provincial level;
(9) Donations made by the public and enterprises.

relevant regulations. As for the part of the income of the not-for-profit scientific research institutions that is derived from non-major business operations and is used as investment in improving conditions for scientific research, it may be deducted from taxable income after examination and approval of the tax authorities.

Interest income earned by public welfare foundations on bank deposits or Treasury bonds is not treated as taxable income for the purpose of Enterprise Income Tax; however, any income derived from securities such as stock shares, bonds (excluding Treasury bonds), and other income, including capital gains, is to be included in the taxable income and is subject to Enterprise Income Tax.

1.4.1.2 Business tax

According to *Law on Business Tax*, the exemptions from Business Tax are based on the characteristics of NPOs and their activities.[7]

1.4.1.3 Value-added tax

According to relevant tax law of China, the importation of instruments and equipment to be directly used in scientific research, scientific experiment, and education are exempt from value-added tax. This exemption lowers the cost of these instruments and equipment, which benefits NPOs if and to the extent that they are the final users or consumers of them.

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[7] The following items are exempt from Business Tax for NPOs:

(1) Nursing services provided by nurseries, kindergartens, homes for the aged, welfare institutions for the handicapped, matchmaking, and funeral services.

(2) Medical services provided by licensed hospitals, clinics, and medical institutions. The medical service remuneration earned by not-for-profit medical institutions, disease control institutions; woman and child health care institutions in line with the State specified prices are exempt from Business Tax. Profit-making medical institutions that use the income directly in improving the medical conditions may enjoy 3 year tax exemption on their medical service income starting from the date of business registration.

(3) Educational services provided by schools and other educational institutions. The "schools and educational institutions" mentioned here refers to ordinary schools and schools of various kinds approved or established by the People's governments above the prefecture and city levels or departments for educational administration under the same level of and where the academic qualifications of their students are recognized by the State.

(4) Admission fees for cultural activities conducted by memorial halls, museums, cultural centers, art galleries, exhibition halls, academies of painting and calligraphy, libraries and cultural protective units as well as admission fees for cultural and religious activities conducted at places of religious worship. The "cultural activities conducted by such units as a memorial hall" mentioned here refer to the cultural activities that fall within the taxable scope of taxable items under culture and sports activities conducted by those units in their own locations. The admission fees refer to the box-office receipts on the sales at the first entrance. The "Admissions fees for cultural and religious activities conducted at places of religious worship" mentioned in this paragraph refer to the receipts on the sales of admission tickets for cultural and religious activities held by temples, Taoist temples, mosques and churches

(5) Fiscal charges and membership fees received by social organizations;

(6) Income derived by not-for-profit scientific institutions from technological development, technology transfer and the related technical advisory services.

1.4.1.4 Tariffs (customs duties)

According to relevant tax laws of China, goods, supplies, and equipment donated as free gifts by foreign governments and international organizations are exempt from tariffs.

1.4.1.5 Real estate tax

There are some exemptions from of real estate tax for NPOs in China.[8]

1.4.1.6 Vehicle and vessel usage tax

NPOs are exempt from Vehicle and Vessel Usage Tax.[9]

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[8] According to the *Provisional Regulations on Real Estate Tax*, the following three kinds of real property of NPOs are exempt from Real Estate Tax:

(1) The real property of governmental organs, peoples' organizations, and military units for their own use. The "peoples' organizations" mentioned here refer to social organizations that are established with the approval of the relevant government department as authorized by the State Council or allowed by government and whose operating funds are derived from State fiscal appropriations. The "real property for their own use" refers to buildings for their own use in office work and public affairs.

(2) The real property of the units for their own use whose operating funds are allocated by State financial departments. Exemption of real estate tax is granted to real property that is for the own use by the government institutions that are under balanced budget administration. The units that obtain their operating funds from the State financial departments and are left to use the financial funds at their own discretion for various expenditures enjoy a three-year-period of tax exemption starting from the date on which they begin to use the financial funds at their own discretion. The "real property for their own use" refers to the buildings of those units that are used for their own business and office work. As to the real property of the various kinds of enterprise-run schools, hospitals, child-care centers and kindergartens, the matter of tax exemption may be handled according to the real property of the units for their own use whose operating funds are allocated by the State financial departments.

(3) The real property of religious temples, parks, and places of historic interest or scenic beauty for their own use. The "real property of religious temples for their own use" refers to the buildings where religious rites are held and the houses for the religious staff to live in, but only if they are used by the organization and not leased to another unit The real property for the own use of parks and places of historic interest and scenic beauty refers to buildings for public sightseeing visits and the buildings where the administrative departments conduct their office work

Any buildings of NPOs that are hired by other units for business operations or that are used by an NPO for business operations do not fall within the scope of this tax exemption and are subject to the tax. Real Estate Tax is imposed on the houses that are used by the units that are set within the parks and places of historic interest and scenic beauty for business operations, such as cinemas, restaurants, teahouses and photo studios. Real estate tax is also imposed on the houses that are let out by such units.

[9] (1) Vehicles and vessels owned by "peoples' organizations," are granted tax exemption, but only if they are used by the organization and not leased to another unit. "Peoples' organizations" refers to social organizations that have been approved by the relevant government department and whose operating funds are derived from State fiscal appropriations.

(2) Vehicles and vessels owned by NPOs that are financed by State financial allocations are not subject to the Vehicle and Vessel Usage Tax, but only if they are used by the organization and not leased to another unit

(3) Certain special vehicles and vessels, such as the epidemic prevention vehicles and ambulances, are granted tax exemption, including those owned by NPOs.

1.4.1.7 Urban and township land usage tax

There are exemptions under the Urban and Township Land Usage Tax for NPOs.[10]

1.4.1.8 Farm land occupation tax

Farmlands that are used by schools, kindergartens, homes for the aged, hospitals (other than convalescent hospitals), funeral homes and crematoria, and other NPOs providing similar public benefit services are exempt from the Farm Land Occupation Tax. The term "Schools" includes institutions of higher learning, middle schools, and primary schools, but does not include for-profit institutions, study classes, training centers, correspondence schools, and the like.

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(4) Vehicles or vessels owned by health care institutions such as the not-for-profit medical institutions, disease control institutions, and woman and child health care institutions are free from the tax but only if they are used by the organization and not leased to another unit. Profit-making medical institutions that use their income directly to improve medical conditions enjoy a 3-year tax exemption on their self-used vehicles and vessels starting from the date of business registration.
(5) Tax exemption is also granted to the vehicles and vessels self-used by not-for-profit welfare agencies established for the old people with investment by government departments, enterprises, government institutions and individuals.

[10] The exemptions are as follows:
(1) The land of peoples 'organizations for their own use is granted tax exemption. The "peoples ' organizations " as mentioned here refer to the various social organizations that are established with the approval of relevant government department authorized by the State Council or have been allowed by government. and whose operating funds are derived from State fiscal appropriations. The land for self use refers to land for their own use for office work and public affairs.
(2) Land for their own use of units whose operating funds are allocated by the State financial departments enjoys tax exemption. The "units whose operating funds are allocated by the State financial departments " refer to the government institutions financed by the State financial departments and are under full budget administration or balance budget administration, excluding [institutions that try to seek for revenues that are to be used all at their own discretion and shall take sole responsibility for their own profits and losses. The land for self use refers to the land used only for the affairs of the units. As for land that is used by schools, hospitals, child-care centers, and kindergartens that are established by an enterprise, if such land can be definitely distinguished from the land that is used by the enterprise for other purposes, then it is free from Urban and Township Land Usage Tax.
Whether there is a tax exemption for the land that is used by the various kinds of schools, hospitals, child-care centers and kindergartens that are established by a collectively owned units and individuals must be determined by the competent tax authorities of all provinces, autonomous regions, and municipalities under the State Council.
(3) Land for self-use by religious temples, parks and places of historic interest and scenic beauty is granted tax exemption. Religious temples refer to the various religious sites such as Buddhist temples, shrines, palaces, Taoist temples, and churches where religious activities are held .and houses for the religious staff to live in. The land for self use of parks and places of historic interest and scenic beauty refers to land for public sightseeing visits and land where the administrative departments conduct their office work.
Any land of an NPO that is used for production and business operations, however, such as cinemas, restaurants, teahouses, and photo studios in parks and places of historic interest or scenic beauty, does not fall within the scope of tax exemption, and NPOs must pay land usage tax on such land.

1.4.1.9 Deed tax

According to the Law on Deed Tax, exemptions from the Deed Tax, or reduced rates, may be granted to land and buildings received by social organizations for office work, teaching, medical treatment, and scientific research,; and exemptions may also be granted to land and buildings received by NPOs for establishing public educational institutions with State financial appropriations and upon approval by relevant competent department.

If a taxpayer that received an exemption from the Deed Tax, or a reduced rate, ceases to operate the facility that qualified it for the tax benefit, it loses its exemption or reduced rate and must pay back the tax that would have been owed if no exemption or reduced rate had applied to any taxes owed for the period after it ceased to operate the facility for a qualifying purpose.

1.4.1.10 Vehicle acquisition tax

There is no tax benefit specifically for NPOs with regard to the Vehicle Acquisition Tax, but any vehicle that is acquired by gift, donation, or self-construction is taxed only at the minimum taxable price as specified by the State Tax Authority from time to time.

1.4.2 Preferential tax policies for enterprises that make donations to NPOs

Enterprises that make donations to NPOs may enjoy preferential tax policies as follows:

1.4.2.1 Land value-added tax

The donation of land or buildings, or the right to use them, to an NPO by *inter vivos* or testamentary gift is exempt from the land value added tax.

1.4.2.2 Enterprise income tax

1) According to the *Provisional Regulations on Enterprise Income Tax*, the amount of any donations made by a taxpayer (excluding a taxpayer engaged in banking or insurance) for community benefit and relief undertakings[11] are deductible under the Enterprise Income Tax up to 3% of taxable income for the tax year. A taxpayer engaged in banking or insurance may also claim a deduction for such donations but only up to 1.5% of the taxable income for the tax year.

[11] "Donations for community benefit and relief undertakings" refers to donations made to or through certain social organizations or governmental organs for education, civil affairs undertakings, natural disaster relief, Red Cross undertakings, poverty relief, old age assistance, or similar undertakings. "Certain social organizations" refers to particular, named organizations that that have been established with the approval of the State Administration of Taxation, namely the China Youth Development Foundation, the Project Hope Foundation, the Soong Ching Ling Foundation, the Disaster Relief Foundation, the Red Cross Society of China, the China Disabled Persons Federation, the Chinese Young Volunteers Association, the All-China Foundation for the Aged, Society for the Promotion of the Old Revolutionary Base Areas, Research Foundation for Chinese Friends, China Greening Foundation, Guanghua Science and Technology Foundation, the China Literature and Art Foundation, the China Population and Welfare Foundation, the China Legal Aid Foundation, and the Yan Baohang Educational Foundation and other specifically named non-profit organizations established with the approval of the civil affair departments for community welfare.

2) Donations made by enterprises, government institutions, social organizations, and other social forces through not-for-profit social organizations (including the Red Cross Society of China) and governmental organs to the Red Cross undertakings may be fully deducted from the taxable income on which Enterprise Income Tax has not yet been paid[12].

3) Donations made to the not-for-profit welfare institutions for the services for the old people by enterprises, state-owned institutions, social organizations, and other social forces through not-for-profit social organizations and governmental departments, may be deducted from the taxable income on which Enterprise Income Tax has not yet been paid.[13]

4) Donations made by enterprises, government institutions, social organizations, and other social forces through not-for-profit social organizations and governmental organs for the purpose of carrying out compulsory education in rural areas may be deducted from the taxable income on which Enterprise Income Tax has not yet been paid.[14]

5) Donations made by enterprises, government institutions, social organizations, and other social forces through not-for-profit social organizations and governmental organs to the public welfare places for youth and teenager activities (including the newly-constructed ones), may be fully deducted from the income on which Enterprise Income Tax has not yet been paid.[15]

6) Donations made by enterprises for the following various cultural, historic, and scientific undertakings through the administrative departments of culture or not-for-profit public welfare institutions that are established with the approval of the relevant department fall within the scope of donations for public welfare and relief undertakings and can be are

[12] "Red Cross undertakings" refers to the activities that are carried out by Red Cross societies at or above the county level as specified in the "Law of the People's Republic of China on Red Cross Society" and "Regulations for China Red Cross Society".

[13] "Institutions for the service of old people" refers to the not-for-profit welfare institutions that are specially engaged in providing old people with daily life care, cultural service, nursing service, health care service, and the like, including social welfare institutions for the aged, homes of respect for the aged, service centers for the aged, apartments for the aged (including nursing homes for the aged, rehabilitation centers and old people care centers).

[14] The range of "compulsory education in rural areas" covers primary schools and junior middle schools in rural townships (excluding the townships where county governments or governments of cities at the county level are located) and villages that are established by governments or social forces as well as the schools for special education of a primary school and middle school nature. Donations made by taxpayers to schools that conduct both compulsory education and senior middle school education are also entitled to enjoy a deduction from taxable income on which Enterprise Income Tax has not yet been paid.

[15] The "public welfare places for youth and teenager activities" refer to public welfare places where various activities are specially held concerning extra-school education in science and technology, culture, moral, and patriotism, such as the children's palaces, children activities centers and the like where children can go to enjoy various extra-school activities.

deductible up to 10% of the taxable income for the tax year.[16]

7) Membership fees paid by enterprises to associations for the benefit of members are deductible from the Enterprise Income Tax without any limit.

1.4.3 Preferential tax policies for individuals who make donations to NPOs

Individuals may claim a deduction from the Individual Income Tax up to 30% of taxable income for the year for the amount of donations made for education, civil affairs undertakings, natural disaster relief, poverty relief, youth and teenager activities, old age assistance, art, science, technology, cultural or historical preservation or memorial, or similar undertakings.

1) For individuals who make donations to educational undertakings and other public welfare undertakings as well as to the areas that are hit by serious natural disasters or poverty-stricken areas through social organizations within China and governmental organs, the part of their donations that is less than 30% of the taxable income is fully deductible from the reported taxable income, while the part of the donations in excess of 30% of the taxable income is not deductible.[17]
2) Donations made by individuals through not-for-profit social organizations and governmental organs to Red Cross undertakings shall, when the amount of Individual Income Tax payable is being determined, may be wholly deducted from the taxable income on which the Individual Income Tax has not been paid when the amount of Individual Income Tax payable is being determined.
3) Starting from July 1, 2001, the donations made by individuals through not-for-profit social organizations and governmental organs for the purpose of carrying out compulsory education in rural areas may be deducted from their taxable income on which Enterprise Individual Income Tax has not yet been paid.[18]
4) Donations made by individuals through not-for-profit social organizations and governmental organs to the public welfare centers for youth and teenager activities

[16] Donations for cultural undertakings refer to:
(1) Donations made to the key State symphony orchestras, ballet troupes, opera troupes, Peking opera troupes, and performing troupes of folk arts;
(2) Donations made to public libraries, museums, scientific and technologic centers, art galleries, memorial halls, or units for protection of cultural and historical relics or revolution history.
(3) Donations made to key units for protection of cultural and historical relics.

[17] The list of "social organizations" that can receive deductible donations made by individuals is similar to the list of social organizations for deductible donation made by enterprises.

[18] The range of "compulsory education in rural areas" covers the primary schools and junior middle schools in rural townships (excluding the townships where county governments or governments of cities at the county level are located) and villages that are established by governments or social forces as well as the schools for special education of a primary or middle school nature. Donations made by taxpayers to rural schools that conduct both compulsory education and senior middle school education are also entitled to a deduction from taxable income on which Individual Income Tax has not yet been paid.

(including the newly-constructed ones), may be wholly deducted from the taxable income on which Individual Income Tax has not yet been paid.[19]

5) Donations by industrial and commercial individuals that make donations for educational undertakings and other public welfare undertakings as well as to the areas that are hit by serious disasters or poverty-stricken areas through social organizations within China and governmental organs, the part of their donations that is less than 30% of the taxable income is fully are deductible from the taxable income but only up to 30%.

Donations that are made directly to individual beneficiaries are not deductible.

Section 5: Problems with China's Current Tax Policies for NPOs

From the above sections it is clear that China has stipulated numerous preferential tax policies for NPOs that cover different kinds of taxes and different provisions. For example, there are preferential tax treatments for NPOs concerning taxes on income, turnovers, and property that have given substantial support to, and have improved, the development of NPOs of various kinds. With the progress that has been made in China's economy and society, however, the demand for services of NPOs does not just arise from the aspects of poverty relief, social welfare, social relief, relief from natural disasters, assistance to youth and the aged, and so forth, but also from an expanded scope of needs and interests, such as medical treatment, legal aid, environmental protection, plant and animal protection, conflict resolution, art, science, culture, and historical preservation.. What is more, there is demand not just for goods and materials and financial aid, but also for services of high quality and with special features. China's NPOs have obviously entered into a new stage of development, and the old preferential tax policies for NPOs can no longer meet the newly arisen needs. Some hidden problems, especially in the tax systems applicable to NPOs, have clearly emerged. The most significant of the problems are as follows:

1.5.1 A unified and comprehensive tax system has not yet come into being with regard to NPOs

NPOs need to have the support of a unified and comprehensive tax system for their further development. To date there are indeed many policies and regulations on taxes for NPOs, but there is no coherent and integrated set of tax policies specifically designed to meet the needs of NPOs and the special role they can and do play in modern Chinese society. This is true even in the *Law on Enterprise Income Tax*, which is one of the major tax laws and the one that has a major impact on the development of NPOs all over China. The lack of specially designated tax policies and administration rules and procedures for NPOs constitutes a significant deficiency in the tax system of China. It both hinders the development of NPOs and does not satisfy the current needs of society.

[19] "Public welfare places for youth and teenager activities" refers to public welfare places where various activities are specially held concerning extra-school education in science and technology, culture, moral, and patriotism, such as the children's palaces, children's activities centers, and the like where children can go to enjoy various extra-school activities.

1.5.2 Some NPOs in China do not comply with currently applicable tax laws.

The current NPOs in China are generally immature, and the operations of some of them are not in line with relevant laws and regulations. Though there are various laws and regulations that clearly stipulate that NPOs are not permitted to engage in profit-making operations, many of the so-called NPOs are actually carrying out various profit-making activities in a manner similar to private for-profit enterprises. For example, the government encourages profit-making private investment in the field of education so that education can achieve development and prosperity. Non-state educational units have always been treated as NPOs by the Chinese government, but the facts that investors often own them and may gain profits from them have vitiated the nature of such units as NPOs. Similarly, many units in the fields of medicine, culture, science, and technology make profits even though they continue to be described as NPOs. The profit-making activities conducted by NPOs not only confuse people about the concept of NPO, they may also reduce donations and support to real NPOs, thus hindering the development of real NPOs and causing damage to the socialist market economy. In addition, if such units are permitted to enjoy the preferential tax treatments set aside for real NPOs, it may be unfair to other enterprises and may cause negative influences on other enterprises, thus doing harm to the construction of a market economy where competition between enterprises is supposed to be conducted on a fair and equal basis.

This situation not only violates the basic meaning of the concept of NPO and is against the original intention for developing NPOs, but it also makes it unattractive to continue the preferential tax policies for them. Nevertheless, the Chinese government has taken a down-to-earth attitude in formulating tax policies for NPOs, that is to say, the tax laws are applied not according to the formal status of an entity as an NPO, but look instead to whether such organizations make profits from business operations. Thus, not-for-profit activities are given preferential tax treatment and profit-making activities are subject to tax. Therefore, the fact that NPOs have not been defined as having made no profits makes it impossible for related tax policies to give full support to NPOs.

1.5.3 The preferential tax policies for NPOs are based on old taxes

The majority of current taxes were set up in 1994 when the last comprehensive reform of the tax system was carried out. Some of the current taxes were in fact established as long ago as the mid 1980’s of the last century, when the planned economy played a dominant role in the levying of taxes. As a result, some of the current taxes in China are not consistent with the development of a market economy or with the new situations and problems arising with the existence and diversity of NPOs. For example, it is stipulated in the tax laws that units whose operating funds are allocated by the State finance are entitled to enjoy some tax preferences and that schools, hospitals, kindergartens and the like that are operated by for-profit enterprises are exempt from taxes.

1.5.4 Limiting certain tax preferences to a few named NPOs violates the principles of legality and equal competition

A unified standard for formulating preferential tax policies for NPOs in China has not been developed. Most of the preferential tax policies were made by way of just being listed or were just made for this or that single NPO. According to the principle of legality, in order to be a valid law, a rule must have general application to a class, not just to a single entity or individual. Under the principle of equal treatment, the same rules must be applied to all entities or individuals that are similarly situated. Under current Chinese tax laws, however, some NPOs receive preferential tax treatment because they are specifically and individually named in the law and some NPOs of the same kind receive received preferential tax treatment while others of the same type do not, which is quite unfair. For example, it is stipulated in current laws that only donations that are made through the dozen domestic designated social organizations are entitled to be deductible and can only be deductible up to 3% of the taxable income of an enterprise for the tax year, while donations that are made to other NPOs are not deductible from the taxable income for the tax year.

It is also unfair that foreign enterprises can deduct contributions to public benefit NGOs up to 100% of their taxable income for the purpose of the Income Tax for Foreign and Foreign-funded Enterprises , while domestic enterprises cannot claim a deduction for such contributions in excess of 3% of their income.

1.5.5 There is no definite policy about tax on net profits derived by NPOs from business operations.

With the establishment of a socialist market economy in China, NPOs are conducting activities in more and more fields. Most NPOs are engaged in some profit-making activities or have some activities for which they charge fees. There are no clear or definite tax rules with respect to such income of NPOs, with the result that the tax administration in this respect is in great disorder, thus hindering the development of NPOs.

1.5.6 The current tax system discourages donation to NPOs

Donations from enterprises and individuals should be a major source of funding for NPOs. China, however, has not developed a tax system that encourages enterprises and individuals to make donations to NPOs. Donations are largely affected by income tax. But China’s tax system is based on turnover tax, while income tax is not a major tax. Consequently, the tax system does not have much effect on donation behavior. In terms of enterprise income tax, China’s tax law prescribes that only the part of the donations made by enterprises that is less than 3% of their taxable income is tax deductible, while the part in excess of 3% is not tax deductible. Such a low deduction limit does not give enterprises much incentive to make donations. In addition, enterprises have to pay tax on the extra amount of donation they make in excess of the limit, which discourages them even more from making donations. Neither is the fixed rate of the enterprise income tax an incentive for donation. In terms of individual income tax, the tax system and tax administration offer low incentive to individuals to make donations. Although the individual income tax adopts the progressive tax rate, the idea of charitable donation has not yet been widely accepted in the society, especially among the wealthy people in China. The Personal Income Tax Law gives relatively few tax benefits for donations with low tax deductible level, which, to some extent, affects the amount of donations to NPOs.

Section 6: Tax Administration for NPOs

There is no tax administration system specially established for NPOs in China. All tax matters affecting NPOs are, as is the case with the profit-making enterprises, settled in accordance with the *Tax Collection and Administration Law* and the corresponding detailed rules for implementation of the law concerning tax administration, tax law implementation, and legal assistance.

1.6.1 Tax registration

All NPOs in China that engage in production and business operations and all NPOs that do not engage in production or business operations but have taxable income must all go through relevant formalities for tax registration in accordance with the *Tax Collection and Administration Law* and the corresponding detailed rules for implementation of the law.

NPOs must apply to the tax authorities for tax registration within 30 days after the receipt of a business license and other relevant approved documents and must provide the tax authorities with the following kinds of materials for tax registration: relevant approved documents such as the business license and the certificate for the legal representative of a government institution, the registration certificate for a social organization, the registration certificate for a privately-run non-corporate unit, as well as other kinds of certificates or evidential papers that authorize the units to conduct business operations; relevant regulations, contracts and agreements; the papers evidencing the bank account number; the resident identification card of the legal representative, the certificate for the identification number of an organization or institution that is issued on a unified basis, etc.

If an NPO changes the contents of its tax registration, the NPO must go to the competent tax authorities to go through relevant formalities for the change of tax registration within 30 days after the NPO has gone through relevant formalities for the change of the registration contents with other relevant departments. If an NPO applies for business deregistration, the NPO must go to the tax authorities for the cancellation of tax registration with the relevant papers before the business deregistration can be carried out.

1.6.2 Administration of accounting books and supporting vouchers

All NPOs, of whatever type must establish accounting books and records in accordance with the State rulings, keep accounting records, and conduct accounting on the basis of legitimate and valid vouchers. If the financial and accounting systems or methods of NPOs are contradictory to the relevant tax regulations formulated by the State Council or the authorized financial and tax departments under the State Council, the calculation of tax payable must be conducted in accordance with the relevant tax regulations formulated by the State Council or the authorized financial and tax departments under the State Council. NPOs must maintain accounting books, supporting vouchers for the accounts, tax payment receipts, and other relevant information within the period prescribed by the authorized financial and tax departments under the State Council.

1.6.3 Tax filing

All NPOs must, within the time limit and in line with the requirements prescribed for tax filing in the relevant taxation laws, fulfill tax filing requirements, submitting tax returns, financial, and accounting statements, as well as other relevant materials on tax payment that are required to be presented by tax authorities. One thing that is to be stressed here is that the NPOs, no matter whether they have taxable income or not, must fulfill tax filing with the tax authorities within the prescribed time limit and in line with the specified requirements. If an NPO is unable to conduct tax filing within the prescribed time limit, it may defer the tax filing with the approval by relevant tax authorities.

NPOs that are entitled to enjoy certain tax exemptions must, when being inspected by tax authorities, provide relevant evidentiary papers as required by the tax authorities.

1.6.4 Tax collection

In order to ensure the payment of taxes owed payable by NPOs within the prescribed time limit, some provisions are stipulated and penalties are established in the relevant taxation laws in regard to penalties. The provisions are generally as follows:

1) For taxpayers that fail to pay tax within the prescribed time limit, a fine is imposed on them on a daily basis at the rate of 0.05% of the amount of tax in arrears, starting from the day the tax payment is in default.

2) For taxpayers that fail to pay tax in accordance with laws and regulations, the tax authorities must assess the amount of tax payable and order the taxpayers to pay it. Should the taxpayers fail or refuse to pay the tax, the tax authorities may impound their goods or property in an amount equivalent to the amount of the tax payable. The goods or property may be held impounded until the tax payment has been made. If the tax payable is still not paid after the impounding, the tax authorities may, in accordance with relevant laws and regulations, sell or auction them off and use the proceeds to make good the amount of tax payable.

   If there are obvious evidences that a taxpayer has transferred or concealed its taxable commodities, goods, or other property for sake of tax evasion, the tax authorities may order the taxpayer to provide a guaranty for tax payment. If the taxpayer is unable to provide a guaranty for tax payment, the tax authorities may take some measures for retaining obtaining tax revenues, such as freezing the taxpayer's bank deposits, impounding, or sealing up the taxpayer's commodities, goods, or property.

3) If a taxpayer fails to pay tax he or it owes within the prescribed time limit, the tax authorities may set another time limit for tax payment and order the taxpayer to pay the tax within the new time limit. If the taxpayer still fails to make the tax payment, the tax authorities may implement utilize the following mandatory enforcement measures: Withhold the amount of tax payable from the taxpayer's deposits in the banks; Impound, seal up, and sell, or auction off the taxpayer's commodities, goods, or other property, in an amount equivalent to the amount of taxes owed payable, and Use the proceeds from the selling or auctioning off to make good the amount of taxes owed.

4) If a taxpayer or its tax agent that has taxes in arrears or its tax agent and intends to go abroad, the taxpayer or its agent must, before leaving China, pay all the taxes owed plus any payable and the fines on the tax in arrearage, or provide a guaranty for tax payment. If the taxpayer or its tax agent fails to pay all the taxes and fines owed payable and the fines on the tax in arrears, or fails to provide a guaranty for tax payment, the tax authorities may ask the administrative authorities to block the taxpayer's exit and prevent the taxpayer or its agent from leaving China.

1.6.5 Tax inspection

According to relevant laws of China, tax authorities are entitled to conduct tax inspection of NPOs in respect to any tax matters. The tax authorities may inspect the accounting books, supporting vouchers for the accounts, statements, and relevant information, commodities, goods and other property, as well as relevant receipts, documents, and related information. If the tax authorities discover, when carrying out a tax inspection, that a taxpayer intends to evade tax or there are obvious evidences that the taxpayer has transferred or concealed its taxable commodities, goods, and other property and income, the tax authorities may take measures to assure that taxes are paid.

In addition, tax laws also provide for administrative sanctions for violations committed by a taxpayer with regard to tax administration, accounting administration, and tax filing as well as for the offenses of evasion of tax, refusal to pay tax, or misrepresentation or fraud.

1.6.6 Administrative reconsideration and legal proceedings concerning taxes for NPOs

In case of disputes arising between an NPO and the tax authorities in respect of taxes owed, the NPO must first pay the tax assessed or provide a guaranty, according to the decision of the tax authorities, and then the NPO may apply for administrative reconsideration. If the taxpayer has objections to the decision made after administrative reconsideration, the NPO may institute legal proceedings with the court in accordance with relevant laws and regulations.

If the NPO has an objection to an adverse decision made by the tax authorities or to mandatory enforcement measures or measures assuring the payment of taxes implemented by the tax authorities, the NPO may apply for administrative reconsideration or may institute legal proceedings with the People's Court in accordance with relevant laws and regulations.

1.6.7 Conclusion

Generally, the administration of the tax affairs of NPOs is lagging behind their development, and it needs much improvement. NPOs are developing very fast, even though they emerged not so long ago. Some elements of governmental administration cannot meet the needs of the development of NPOs. For example, once established, NPOs are only entitled to make industrial and commercial registration, but not civil registration, for the administration of the various certificates, receipts, vouchers, and other documents of a similar kind for NPOs, so that many returns and financial statements, etc., that are specially intended for business-operating units, are required to be filed by NPOs. Furthermore, there is no set of special financial accounting rules tailored to the different and special characteristics and needs of NPOs. In short, tax administration for NPOs is not conducted in line with the unique features of NPOs, and this has a negative impact upon the normal performance and development of NPOs.

Section 7: The Impact of the Chinese Tax System on NPOs

Although there are no tax laws specially formulated for NPOs in China, some unique tax policies have been made for NPOs so that the tax affairs of NPOs can be administered and managed in a way more characteristic for NPOs. These policies have so far produced great influence upon and given strong support to the development of NPOs, especially since the implementation of the policy of reform and opening up to the outside world during the course of which the Chinese economy has achieved a rapid development. The number of NPOs greatly increased during this period as one after another preferential tax treatments was provided for NPOs. NPOs, grew from weak to strong, from few to many, and with their growth they have contributed much to the economic and social development and stability in China. Although preferential tax policies have encouraged and stimulated the development of NPOs, they have not yet played their role to the fullest extent.

1.7.1 There is no comprehensive and supportive tax system especially designed for NPOs

Although there are quite a large number of tax policies for NPOs that cover different kinds of taxes, there is no comprehensive and supportive tax system especially intended for them. As a result, China's tax legislation urgently needs amplification and development with respect to rules affecting NPOs. On the one hand, there has been no clear division made between the public benefit NPOs and mutual benefit NPOs within the tax system, and the preferential tax policies stipulated in various tax laws and regulations are applied universally to NPOs of both types. This makes it impossible for the public benefit NPOs to enjoy more preferential tax treatment, a situation that restricts their growth and contribution to Chinese society. On the other hand, although a great number of preferential tax policies have been established, the current impact of these preferences is small. In short, the Third Sector remains weak because of the lack of coherent tax policy for NPOs.

1.7.2 China is exercising strict control over NPOs in the tax administration process

As far as tax administration is concerned, China conducts relatively strict administration over NPOs with respect to taxes. For various historical reasons, Chinese enterprises and citizens do not have a strong sense of their duty to pay tax in accordance with laws and regulations. In addition, in order to prevent some units and individuals from committing illegal acts such as evading tax and laundering money by taking advantages of the preferential tax treatments for NPOs, China is retaining tight control over NPOs in respect of their tax payments. It is required that all NPOs of different types must go through the formalities of tax registration and tax filings and that, no matter whether they have taxable income or not, that NPOs must make tax filings on time. What is more, the NPOs that are entitled to enjoy preferential tax treatments are required to provide a wide range of evidentiary papers to the tax authorities even though those papers may be completely irrelevant to their situation or operations. This type of tax administration has increased the administrative burden on NPOs without creating any benefit to society.

1.7.3 There are problems in publicizing and implementing tax policies for NPOs

As far as the preferential tax policies are concerned, there are still problems in publicizing and implementing them and thereby increasing the amount of benefit of NPOs get as a result of these preferences to NPOs through them. Although China is improving its efforts to publicize tax laws, its efforts in publicizing the preferential tax policies for NPOs still need to be strengthened. Quite a few NPOs do not have any idea or know very little about the preferential tax treatments available to NPOs, so they have not received the support intended for them. Because NPOs must go through a set of procedures, including strict examinations and verifications, in order to accomplish their registration, many would-be NPOs have chosen to register with the industrial and commercial departments. As such, they are not entitled to tax preferences even though they are in actuality not-for-profit organizations.

It is even more of a problem that China has not adopted much more preferential tax policies for the public benefit NPOs. The products and services provided by public benefit NPOs by definition benefit society in ways desired by the government. Many countries in the world other than China extend the most preferential tax policies to such NPOs, as explained in Part II. Currently, it is not stipulated in the Chinese taxation laws that the NPOs are to be divided between PBOs and other NPOs.

In addition, China's tax laws impose restrictions upon the profit-making operations and activities of NPOs, and these rules also prevent NPOs from generating funds to support themselves and to contribute more effectively to society. The reality in China is that NPOs have very few financial sources from which they can derive funds, and their main financial resource remains governmental finance. Funds raised from the public, from enterprise donations, and from gains from their own business operations apparently account for only a very small part of their gross income, which greatly handicaps the development of NPOs. In sum, a great deal needs be done to create better tax policies for NPOs so that they may more fully contribute to the development of a strong, vigorous, and stable society in China.

Part II Tax Rules for NPOs in Other Countries: A Survey of Practice

Introduction. This part of the Report describes 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. Detailed descriptions are provided of the tax laws affecting NPOs in Germany, the United Kingdom, and the United States in separate Appendices. As a leading scholar of comparative tax law has stated, "a focus on these three countries (Germany, U.K., and U.S.) will reveal most of the basic contrasts that would arise from including other countries in the study."[20] In addition, other Appendices discuss taxation of NPOs in Japan and the countries of the former Soviet Union; how certain nations deal with the question of NPOs that engage in commercial activities (South Africa and France); "Model Provisions" for laws governing public benefit organizations; and numerical examples showing the difference between various tax preferences for donations.

The purpose of this part of the Report is to provide a broad understanding of how NPOs are taxed in countries around the world. This will enable policy-makers to choose among different alternatives and draft tax laws appropriate for NPOs in the Peoples' Republic of China.

1. What are NPOs and PBOs?

As indicated in the Introduction and Overview, 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 Report, 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.

[20] Victor Thuryoni, COMPARATIVE TAX LAW 9 (Kluwer 2004).

2. Income or Profits Tax[21]

2.2.1 Income or Profits Tax Exemption in General[22]

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.[23] 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, and thus it can be strongly argued that they should not be subject to income taxation at all.[24] 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.[25] Nevertheless, most countries do grant broad tax exemptions and other tax benefits to NPOs, especially PBOs.

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[21] 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.

[22] Although NPOs are referred to as *being* exempt from taxes throughout this Report, 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.

[23] 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.

[24] 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).

[25] 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 22.

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 or assets. The first two groups of revenue sources – donations (gifts, grants, subsidies, etc.) and membership dues – are generally not taxed to NPOs in countries aroujnd the world, for the tax laws do not ordinarily include such items in the definition of income.[26] 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 exclusion warrants non-inclusion of such items in the income of NPOs.[27] 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 generally equal 100% of the donation,[28] 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 all 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.[29] PBOs, called in the legislation "charitable organizations," 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.[30] 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 member services in return for the receipt of the dues. In addition, unlike charitable gifts, membership dues generally are not deductible to the donor, nor are membership benefits generally treated as income to the recipient. There may, of course, be a timing problem in that member services may not be received in the taxable year in which the

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[26] 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 a business activity.

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

[28] As described in the chart attached as Appendix G, 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.

[29] 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.

[30] See Tanzania Report in IJCSL-N for August 2004.

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.

2.2.2 Income Earned on Investments (Endowments and Reserves)

Exclusion from income may or may not apply with respect to "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.[31] Under this approach, and in common 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.[32] 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.[33] In the United States passive investment income of PBOs (public charities and private foundations) is not subject to tax.[34]

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.[35] In Madagascar, for example, the investment income of a foundation is taxed, consistent with the practice in Francophone countries of taxing the passive income of all taxpayers. France grants a set of special tax exemptions for the investment income of public benefit foundations, but these rules do not seem

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

[32] 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.

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

[34] See Appendix A.

[35] It may be 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 5 at 48 (1994).

For a discussion of these issues in the context of the Hungarian legislation, see Nilda Bullain, *The Legal Environment for Endowments in Hungary*, 4 Int'l J. of Not-for-Profit L 4, http://www.icnl.org/journal/vol4iss4/cr_cee.htm#Hungary (June 2002).

to have found their way into the Malagasy legislation.[36] 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 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.[37] 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 to allow any legal investments but to subject all investments to a "prudent investor" standard.[38]

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 tax rule that requires minimum distributions or spending of the earnings, as in the United States, Canada, or Germany.[39] Such rules generally impose a penalty tax if the earnings are not spent within a specified amount of time.

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[36] Under the Code Genéral 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.

[37] 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.

[38] See Marion Fremont-Smith, GOVERNING NON-PROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION (Harvard University Press 2004), at 454. Modern investment standards also permit a "portfolio" approach, under which investments must be diversified among types of investment and should include investments with varying levels of risk versus reward.

[39] See 26 U.S.C. §4942, a provision of the U.S. Internal Revenue Code that imposes a tax on a private foundations that fail to distribute a minimum amount of their investment income (equal to approximately 5% of assets) for public benefit purposes. For a discussion of the rules in Germany, see Appendix C. 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 assets, a rule requiring minimum distributions should take account of actual investment returns and inflation rates, which vary greatly. One sensible approach would be to require distribution each year of one half of real, inflation-adjusted income.

The income-oriented approach adopted in Tanzania, see note 27, supra, is similar to the rule in India, which 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 of India 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. Similarly, a "private foundation," a grant-making type of PBO in the United States, must generally seek advance IRS permission to count a set-aside as a "qualifying distribution." See I.R.C. §4942((g)(2).

2.2.3 Income or Profits Taxation of Business Activities

Unlike the general rule exempting all NPOs from taxation on income from donations and membership fees, the profits of NPOs from the active conduct of a trade or business are generally taxed while such income of a PBO may or may not be treated as tax exempt, depending on the rules applied in a given country. Like income from passive investments discussed in paragraph 2, business income is clearly income in the normal understanding of the term.

Business activities raise two different questions: (1) to what extent should NPOs and PBOs be allowed to conduct them at all, and (2) how should profits from such activities be taxed? Business activities may be conducted be NPOs and PBOs 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.[40] 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 – that is, the activities, including the business activities, of an NPO must generally support its not-for-profit purposes.

The question of whether business activities do or do not further the not-for-profit purposes of an organization is even more fundamental in determining whether an organization qualifies as a PBO 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.[41] 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.[42] 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 essentially mechanical tests.[43] Thus, if more than 50 percent of the activities and expenditures of an NPO constitute non-purpose-related business activities for a significant period of time (e.g., 3 years) the organization should be required to be re-registered as a business entity. And, an organization cannot qualify as a PBO if it engages to more than an insubstantial extent (e.g., more than 5%) in activities, including business activities, that do not further its public benefit purposes. To the extent that any business

[40] For activities to constitute "business activities" there must be the "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, and so forth, are generally not treated as business activities.

[41] E.g., Treas. Reg §1-501(c)(3)-1(e)(i).

[42] 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, "exclusively" does not mean 100%.

[43] See infra text at notes 50-52, infra, for a discussion of other forms of mechanical tests.

activities are permitted for either NPOs or PBOs, it is a separate question whether and the extent to which tax should be imposed on any profits earned from such business activities.

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

1) exempted from income taxation;
2) subjected to income taxation;
3) 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;
4) 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
5) subjected to income taxation under a complex rule that combines some aspects of more than one of the preceding rules.[44]

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 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 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.[45]

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

[44] 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 discussion in Appendix F.

[45] 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.

purpose-related activities.[46] 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 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 business 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 business 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.[47] Some countries (e.g., France) do so if the NPO is operated on a commercial basis and in fact competes with for-profit companies.[48] Other countries (e.g., the United States[49]) 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.[50] 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,[51] then exempting from taxation the profits from publication and sale of the PBO's magazine may make good tax policy sense.

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[46] 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.

[47] 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).

[48] See Appendix F for a discussion of the "commerciality" test as it applies in France and South Africa.

[49] 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 Appendix A for a discussion of these rules.

[50] 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 income taxation on this income.

[51] 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's article cited in note 42,

Unfortunately, it is often difficult to distinguish "related" economic activities from "unrelated" economic activities, and hence the related/unrelated rule can be 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.[52] 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 these relevant considerations is not easy. The amount of revenue raised by the U.S. tax on "unrelated" business activities, however, indicates that the distinction can be effectively applied, with the result that significant tax revenues are raised from unrelated business activities.[53] 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 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.[54] But, as applied in most countries that use it, the real

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supra. See also the discussion in paragraph (3) on page 20, op cit. supra. Note that in Procedural Recommendation 1.32, this Report proposes that compensation limits be applied to PBOs.

[52] An extensive discussion of this example and the ways in which the tax laws of France and South Africa might apply to it is found in Appendix F.

[53] 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. 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. 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).

[54] This rule justifies the exemption of 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, such health, educational, and cultural not-for-profit entities usually render substantial services free of charge or at a reduced rate to 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.

"*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.[55]

One possible alternative, used in Poland until the mid-1990's, would permit a PBO to be exempt from tax on profits from any business activities (both purpose-related and regular business activities) so long as that profit was spent for carrying out its 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 necessity of distinguishing between money that was earned this year or last rather than in an earlier year.[56]

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 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 economic activity income it is more like a business than an NPO.[57]

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. But if the threshold is exceeded and other qualifying tests are not met, public benefit status is entirely lost; this is a much harsher outcome than that in Hungary.[58]

As this discussion makes clear, the standard practice around the world is to allow PBOs to engage in related business activities to any extent and in unrelated business activities only to a very limited extent. The rule that NPOs should be re-registered as business organizations if they are not predominately engaged in business activities is also widely accepted. The rules

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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 for income or profits tax purposes whether the organization was regarded as tax exempt or not.

[55] For example, OXFAM is exempt from tax on its profits from selling second-hand clothing in developed countries, an activity not related to its basic purposes, because all of those profits are used to pursue its charitable purposes of helping poor people in developing countries.

[56] 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 Appendix C.

[57] For further discussion of this and other mechanical tests, see *CEE Tax Survey*, supra note 35.

[58] For further discussion of the tax rules applicable to commercial activities of NPOs in South Africa, see Appendix F.

applicable to taxing income from allowable business activities of NPOs and PBOs, however, vary considerably from country to country.

2.2.4 Political Activities of Tax Exempt NPOs

There has been a tendency, as exemplified by a paper that ICNL published in 1996 entitled "*Public Policy Activities of Not-for-Profit Organizations*,"[59] 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.[60]

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.[61]

In Germany the restrictions on the political activities of "public benefit organizations" can be found in 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" by "public benefit" organizations is permissible so long as the accomplishment of a public benefit purpose is linked with the 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.[62] In contrast, an organization that has a political goal as its only or its primary purpose would not qualify as a public benefit organization.

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[59] "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.

[60] As revised in recent years, however, English charities may engage in "lobbying" or "campaigning" if it is incidental to and in pursuance of their principal charitable purposes. See *id.*, for a discussion of the rules in various common law jurisdictions.

[61] 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).

[62] 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

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 generally not subsidize the political activities of anyone, no matter what individual or type of entity is conducting them).[63] 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 parties[64] – NPOs that are not treated as "public charities"[65] -- 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

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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 (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).

[63] 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 charities 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).

[64] See Internal Revenue Code §§ 501(c) (4) & 527.

[65] 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 Appendix A. The rationale for making the distinction is a purely regulatory one.

office), though permitted for NPOs in some civil law jurisdictions,[66] tend to be prohibited for tax exempt NPOs in most countries.

2.2.5 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.[67] 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.[68] Under either a credit or a deduction scheme, the amount of revenue lost is only a small 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.[69]

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* for individuals (as in Hungary, Slovakia, Lithuania, Poland, and Romania).[70] Under such a scheme, the taxpayer pays all of his/her taxes to the government, but also sends along a

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[66] 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.

[67] 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), *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.

[68] 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 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).

[69] Consider a simple example: If TP has income of 10,000 and is subject to tax at the rate of 30%, he will pay 3,000 in taxes. If the law is amended to allow a deduction for gifts to PBOs for public benefit purposes (as defined by the State), and this causes TP to make a donation of 1,000 to a PBO, the donation will reduce his taxes to 2,700. Thus, by allowing a deduction for donations to PBOs, the State will have generated 1,000 for a purpose it has approved at a cost of only 300.

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

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 NPOs should not be taxed on donations they receive. If, in addition, the donor is entitled to a tax credit or a deduction against his/her personal or its business income tax, or if the NPO is permitted to reclaim the tax benefit the donor would have received, the same donation receives a double tax preference.[71] This generous tax treatment is deemed justified when the activities of the organization in question are for public benefit.[72] 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 authorities tend to proceed on a case-by-case basis, looking at the purposes and activities of each NPO.[73]

As described above, there are essentially four different types of tax rules for donations, *deductions*, *credits, tax benefit reclaim schemes,* and *tax designation schemes*.[74] 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 transfer of 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 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

[71] A tax designation scheme is 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 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 PBOs.

[72] India provides an example where a tax deduction scheme made a significant difference. 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 22, at 23-24.

[73] 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, included here as Appendix H.

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

value of a credit is the same for all taxpayers, however, a credit will reduce the taxes of a lower bracket taxpayer by a larger percentage.[75]

Most countries with progressive rate structures allow deductions rather than credits.[76] This approach is supported by data that show that lower income individuals generally tend to make charitable contributions without regard to their tax impact. Moreover, other tax rules often preclude them from receiving any tax benefit at all from a charitable contribution.[77] 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.[78]

If the tax system permits tax benefits for contributions to PBOs, it is important to set the limits, if any, on the amount of allowable tax benefits. 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,[79] 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.

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[75] See Appendix G.

[76] 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 31. 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.

[77] 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. Pending tax reform proposals, however, contain provisions that would allow non-itemizers to claim a charitable contribution deduction, albeit 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 81, infra.

[78] 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).

[79] The limitations in the United States are considerably more complicated than can be addressed here. See Appendix B for a more detailed discussion of U.S. law.

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 is generally thought appropriate for each citizen who is financially able to should 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 deduct double the amount of money contributed to approved charitable organizations, called Institutions of Public Character (IPCs), in the succeeding 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![80]

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 in 1988.[81]

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 he/she 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.[82] 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 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.[83]

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[80] For further discussion of this change see the August 2004 issue of IJCSL-N and the authorities cited therein.

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

[82] See Appendix B, where the mechanics of such a scheme are explained.

[83] See generally 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), included here as Appendix B.

In addition to these tax rules, Hungary, Slovakia, Lithuania, and Romania, and possibly Poland,[84] 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 PBOs designated by them.[85] By providing a simple mechanism for directing tax funds to PBOs, the "1 % Law"[86] in Hungary, which has been in operation since 1996, enabled nearly 45% of taxpayers to designate nearly 10 billion forint (about € 39 million) [87] to support socially beneficial activities.

2.2.6 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),[88] although the precise range of preferences varies from country to country. For example, in Germany the rules were traditionally quite broad, but now, with VAT harmonization slowly progressing in the European Union, the range of preferred activities is smaller.[89]

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

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

85 For further discussion of the different countries, see *CEE Tax Survey*, supra note 35. 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 I. Golinski, "Poland's One Percent System," http://www.onepercent.hu/Dokumentumok/Chapter_4_Golinski_Pl.doc (2003).

86 See Istvan 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; G. Posch, *How Hungary's One Percent Law is Applied*, http://www.onepercent.hu/Dokumentumok/Chapter_4_Posch_Hu.doc (2003).

87 See T. 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 totaling nearly 10 billion forints (about 39 million euros)."

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

89 See generally the 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."

organization it cannot apply for a rebate or claim a deduction of 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 any VAT.[90] 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.

One of the possible solutions would be to elect to be included in the VAT system[91] 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.[92] 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.[93]

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 not lower than 5%, on certain socially desirable goods and 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%.[94] The lower rate of VAT tends to make the preferred goods and services cheaper for each purchaser of them, including the ultimate consumer.. The first seller in the chain, however, that sells the item in the form of a good or service that is exempt, will be able to claim a rebate or credit for the input VAT it paid on the inputs that went into making them only up to the amount of the output VAT on the preferred items, which will have been calculated at a rate lower than the standard rate. To make up the difference, this seller is likely to add the amount of its input VAT with respect to which it cannot claim a rebate to the price of the goods or services it sells, thus raising the price.

An approach that would lift much of the heavy burden of VAT without imposing undue administrative complexity 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,

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[90] For further discussion of this problem, see Gejms-Onstad, op.cit., supra note 57.

[91] 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 must be 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 96).

[92] 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.

[93] 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).

[94] For a fuller discussion of VAT issues, IMF, THE MODERN VAT (2002); see also, Williams, op. cit., supra note 33.

say, to 75% of the net amount of VAT paid.[95] Alternatively, PBOs could apply for a VAT rebate equal to a portion of the VAT paid as most goods and services they purchase for their everyday operations. In Canada, for example, PBOs are permitted a "public services bodies" rebate of 50% on their "eligible expenses."[96]

2.2.7 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.[97] 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 NPO[98] 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. An additional problem is caused by the fact that most bilateral and multilateral funders of humanitarian relief and development projects forbid any of their funds to be used to pay 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, and allowing exemptions for PBOs working for multilateral and bilateral funders but not for others raises a serious issue of horizontal equity.[99]

Most countries therefore provide customs duty and import VAT exemptions for PBOs. But if such exemptions are available, there must also be a fair but thorough process for assuring that

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[95] Whether such a rebate scheme would pass muster under the EU's Sixth Directive has not been decided.

[96] See Terrance S. Carter, *Charities and the CIST/HST*, available at www.carters.ca/pub/bulletincharity/2004/chg1152.pdf.

[97] 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.

[98] Called "suitcase NPOs" in East Africa.

[99] 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 22.

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.[100] Even certified PBOs, however, may be required to seek specific exemptions for particular goods they want to import.[101] 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.

2.2.8 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. Most countries of Central and Eastern Europe give different some real estate tax benefits to NPOs.[102] 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.[103]

2.2.9 Employment tax rules

NPO employees typically expect and receive a lower level of compensation than that which is paid for comparable work in the for-profit sector Arguments have been advanced that, because NPO workers are paid less than workers in the for-profit sector, 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.[104] On the other hand, employees of NPOs should not suffer the

[100] Exemption at the border, however, offers serious possibilities for corruption. See Williams, op.cit., supra note 33.

[101] 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.

[102] See *CEE Tax Survey*, supra note 31.

[103] 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 31.

[104] 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.

double disability of working for a lower wage and being excluded from basic employee benefit programs provided for other employees in the society.

2.2.10 Tax Administration

In countries around the world, the tax rules and preferences that apply to NPOs and their donors are generally applied by the officials and agencies generally responsible for taxes. There may be different authorities to handle different taxes, such as the income tax, VAT, customs duties, and real estate taxes. In many countries, each tax authority develops its own rules and procedures and may define basic terms, such as "public benefit organization," differently.[105]

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.[106] 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,[107] and some tax authorities have separate units to deal with NPOs.[108] 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.[109]

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.

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[105] 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.

[106] This is true in the three countries discussed in the first three appendices – the U.S., the U.K., and Germany.

[107] 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/.

[108] 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.

[109] 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/.

2.2.11 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,[110] 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. Model Provisions for establishing and operating a PBC, which deserve close attention, are set forth in Appendix H.

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 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, 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, 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.

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 there is no parliamentary representation on the PBC (e.g., in England and Wales), 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

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

community. The presence of PBO representatives protects against repressive or discriminatory decisions and increases the confidence of the public.

The 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.[111] In the Philippines, the 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 PBOs.[112] 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.[113]

Conclusion. This part of the Report 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 state wishes to support and encourage. As can be seen from this 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.

[111] For a general discussion of NPO certification models, see Special Section of Articles on NPO Certification in the October 2004 issue of IJCSL, at www.law.cua.edu/students/orgs/IJCSL/.

[112] For more information on the PCNC, see www.pcnc.com.ph.

[113] For more information, see www.pcp.org.pk/certification.htm.

Part III Recommendations for Reform

Introduction. The analysis in Part I indicates that there are a number of problems with the current Chinese tax policies that apply to NPOs. In addition, Chinese NPOs are still at a preliminary stage of their development, and they are not well-regulated. It is clear therefore that one aim of any reform of the tax laws applicable to NPOs is that a better system of oversight and regulation should be created so that tax preference are applied fairly and are not abused. As the analysis in Part II suggests, there are examples from other countries that can contribute constructively to a discussion of possible reforms of the tax system applicable to NPOs in China. In this Part III the Report discusses possible reform measures that may be undertaken to further strengthen and clarify the tax system for NPOs in China in an effort to modernize and streamline it as well as to make it more supportive for NPOs, and especially for PBOs.

It is clear that during the 21st century some of the functions once performed by the Government of China will be transferred to NPOs. In fact this is already occurring in many fields, such as charity, science and technology, education, public health, culture, and sport.[114] Assuming more responsibilities important opportunities for the development of NPOs. Not only will the sector grow, but it will be regarded with more respect. Consequently, in order to promote and encourage the development of NPOs to meet the demands of the new era, the current tax system concerning NPOs should be better structured in several aspects. In general, two aspects of the reform go hand-in-hand.

1) NPOs, especially PBOs, should be accorded more favorable tax treatment so that they can work more effectively to meet the needs of the Chinese people.
2) At the same time, the system must be constructed to prevent abuses by unscrupulous organizations that seek tax advantages to which they are not entitled.

This part of the Report discusses the approach to reform that will best meet the current and future needs of Chinese society and the NPOs that serve it in so many different ways. Part A elaborates several general principles that should govern any reform efforts. Part B discusses in detail concrete proposals for the reform of the substantive tax laws (Substantive Recommendations) and applicable procedures (Procedural Recommendations). Decisions to make, or at least initiate, these reforms could be made as part of the fundamental reform of the tax system currently underway, though some of them would take a period of time to accomplish fully.

1 Basic principles for reform of the tax system for NPOs

NPOs are regarded as the "third sector" of Chinese society, and they exist separate from the government and business sectors. Three facts provide theoretical and practical support for the favorable tax treatment of NPOs: First, because they are independent of both market forces and political demands, NPOs are not subject to certain weaknesses of the government and the market. Second, NPOs can perform many positive functions for society, and these supplement the functions of the government and the market. Third, NPOs are sometimes able to provide needed

[114] For a discussion of these developments, see Chunlin Zhang and Nan Jia, The Economics of Nonprofit and Its Relevance to China's Public Service Unit Reform: A Survey of Literature, World Bank 2003.

goods and services on a more efficient and effective economic basis because they are able to mobilize volunteers, because they do not distribute profits, because they operate with lower salaries and overhead costs, etc.

In developing the relevant tax reform policies for NPOs in China, five basic principles should be followed.

3.1.1 <u>Differentiate For-Profit Entities from NPOs</u> -- Existing Chinese non-governmental organizations should be classified into profit-making entities and not-for-profit-making entities. Only real NPOs – those that do not have profit-making as their principal goal and that do not distribute profits -- should be permitted to be registered as NPOs.

The term "NPO" implies a key feature –- NPOs do not have profit-making as one of their basic aims, a feature that makes them different from other kinds of non-government organizations, such as enterprises. In fact, it is clearly stipulated in relevant Chinese laws and regulations on social organizations, foundations, and privately-run non-enterprise units that these organizations may not have as their principal purpose the aim to make and distribute profits. Practically, however, past and current practices have shown that many so-called "NPOs" are in fact engaged in profit-making activities of various kinds and some even have profit-making as their principal purpose. Furthermore, some NPOs have accepted investments from profit-making enterprises and individuals who expect a "return" on their investment. These kinds of practices not only make the term "NPO" confusing but also place obstacles in the path of the future development of NPOs.

In addition, Chinese regulations on NPOs pay insufficient attention to the prohibition on profit distribution. In countries that have a mature legal system for NPOs, it is this "non-distribution constraint" that most clearly marks the difference between for-profit and not-for-profit organizations. Thus, although NPOs are permitted to make some profits, they must use all those profits for their not-for-profit purposes. Most importantly, they are not permitted to distribute any profits, assets, or earning to owners, managers, founders, investors, or any other persons, either during their operations or upon their dissolution, except in fulfillment of their not-for-profit purposes.

Accordingly, any NPOs that have profit-making as their principal purpose or that permit any distribution of profits (including to for-profit investors) should, no matter what kinds of undertaking they conduct, be registered and administered as business organizations or for-profit enterprises. Only organizations that that do not view profit-making as their principal purpose and that do not permit any distribution of profits in any manner should be registered and administered as NPOs. As a result, for example, a private school or medical clinic that has profit-making as its principal purpose or that permits distribution of profits to for-profit investors or others will not be treated as an NPO despite the fact that it has the purpose to provide education or health care. In sum, the "non-distribution constraint" is the feature that most fundamentally differentiates not-for-profit organizations from other non-governmental organizations. This crucially important feature justifies the use of tax laws to support the socially meritorious activities of NPOs, especially PBOs.

3.1.2 <u>Differentiate PBOs from Other NPOs</u> -- NPOs should be divided into public benefit NPOs (PBOs) and regular NPOs (non-PBOs); this will require that the law or regulations be amended to provide a definition of "public benefit."

Many kinds of the activities carried out by NPOs are supplementary to the functions of the government, but the extent to which NPOs provide services or engage in activities that can be considered to benefit the public varies from one NPO to another. NPOs that carry out activities only for the benefit of members instead of for the general public should generally not be classified as public benefit organizations. Even though they do not have profit-making as their principal purpose and even though they do not permit profits to be distributed, their activities are intended for mutual benefit, and as such, they do not deserve the higher level of tax benefits accorded to PBOs.

Accordingly, the distinction between PBOs and other NPOs is of fundamental importance to any sound revision of the tax law in this area. This Report recommends that a "not-for-profit organization" (NPO) be defined as (1) a self-governing legal person (2) that is not organized or operated to make 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. A "public benefit organization" (PBO) should be defined as (1) an NPO, (2) that is organized and operated exclusively for public benefit purposes by (3) engaging in public benefit activities that (4) benefiting (a) all members of the community or (b) some particular group that is disadvantaged or otherwise deserving of special assistance (e.g., artists, musicians, or scientists).

"Public benefit activities" could be defined to include, to the extent they provide a public benefit, (a) the prevention and relief of poverty, (2) the advancement of education or spiritual well-being, (3) the treatment of illness, accident, or disability, (4) the advancement of health, (5) social and community advancement, (6) the advancement of amateur sport, (7) the promotion of civic rights, conflict resolution, and reconciliation, and (8) the advancement of environmental protection and improvement.

The same definitions of public benefit organization and public benefit activities should be used for purposes of the income tax, the value added tax, the business tax, and customs duties.

3.1.3 <u>Implement Fair and Effective Regulation</u> -- NPOs' activities must be effectively and fairly regulated in accordance with relevant laws and regulations so that they do not take advantage of any tax preferences made available to them.

It is an international good practice to adopt preferential tax policies for NPOs in order to stimulate and promote the development of NPOs. But NPOs must be regulated fairly and effectively by the individuals and businesses do not take improper advantage of preferential tax policies available to NPOs. This is important not only for the protection of the State treasury but also for the NPO sector itself-- if some NPOs come instruments of tax evasion, this can discredit NPOs in general and impede their healthy development.

Many countries in the world have detailed tax laws and regulations to prevent NPOs from abusing their tax preferences. In China, however, many businesses are conducting profit-making activities even though they are nominally called NPOs. In short, they are improperly enjoying preferential tax policies specifically formulated for NPOs. Any changes in the tax laws for NPOs should carry include strict reporting and accountability requirements to ensure that no business organizations receive the tax preferences set aside for NPOs. This Report includes proposals for such rules found in the Procedural Recommendations.

3.1.4 <u>Stricter Regulation for PBOs</u> -- The regulation of NPOs should be proportional to the benefits they receive, which means that PBOs should be regulated more strictly than other NPOs because they should receive greater tax benefits.

The discussion of reform of the tax administration system as it applies to NPOs suggests that not only must there be a differentiation in substantive rules for NPOs and PBOs, but that there also be differences in the procedures that apply to them. Thus, PBOs should be subject to more stringent record-keeping and reporting requirements than NPOs, they should face different and more severe sanctions than NPOs, and they should be subject to higher governance requirements and public oversight.

3.1.5 <u>Principle of Legality</u> -- Similarly situated entities (e.g., all PBOs) should be treated the same, and differently situated entities (e.g., NPOs and PBOs) should be treated differently. All persons of a particular kind (e.g., enterprises or natural persons) receiving tax preferences for donations should be treated the same.

The principle of legality requires that similarly situated taxpayers should be treated the same. Moreover, uniformity is a crucial aspect of tax reform for NPOs, for it will help to avoid tax evasion that may otherwise be possible through choice of certain forms that accord more benefits than others. Thus, once NPOs and PBOs are classified according to their characteristics, they should be treated uniformly.

Examples of uniform treatment that should be provided to similarly situated entities or donors include the following. (1) All NPOs should be subject to tax on their investment income, regardless of what types of activities they undertake, whereas PBOs, in contrast, should be tax exempt on investment income. (2) There should be no tax preference for donations to NPOs, but those for donations to PBOs should be retained and improved. (3) The percentage limits for donations to PBOs under the Enterprise Income Tax and the Foreign and Foreign-owned Enterprise Income Tax should be made uniform, so that domestic and foreign enterpriseses are treated the same. (4) Donations to any PBO, not just those favored on a list, should be deductible.

2. Substantive Recommendations for Reform of the Tax System for NPOs

Although China's current tax system has provided significant tax benefits for NPOs, the rules have not been systematically developed and current tax preferences for NPOs are not sufficient to meet the current and future demands of China's social development. In order to further promote NPOs, the tax system for them should be further standardized in line with the above-mentioned principles, and the tax preferences should be clarified and made more consistent. The following discussion focuses on different taxes and tax preferences that apply to NPOs in China and makes reform suggestions consistent with the analysis in Parts I and II. Consistent with the principles that apply whenever tax laws are reformed, these proposals recognize the need to strike a balance between equity, effectiveness, and efficiency, as well as the need to take into account the constraints imposed by limitations on tax administrative capacity.

Decisions to proceed with all of the Report's recommendations could be made as part of the comprehensive tax reform currently underway, but full implementation of some of them will take extended periods of time and can, of course, only take place within the context of Chinese legal and practical realities.

3.2.1 Definition of NPO --MOCA, MOF, and SAT should develop rules and regulations clarifying that an NPO is (1) a self-governing legal person (2) that is not organized or operated to make 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.

Rationale: If the principal purpose of an entity is to conduct business for profit or if it can or does distribute profits directly or indirectly to owners, investors, or other interested persons, then it must be registered as an enterprise, not an NPO. The rules should permit annual government oversight of the operations of all NPOs to ensure that they do not take improper advantage of the tax benefits they receive by distributing profits or engaging principally in commercial businesses.

One of the principal problems faced by the NPO sector in China and the bodies that are charged with supervising and managing it is the fact that there are currently no adequate rules that can be applied to distinguish real NPOs from for-profit organizations (FPOs) that operate under the "NPO" name or that distribute profits to for-profit investors or others. Under this recommendation, basic principles for making the FPO-NPO distinction would be stated in law and the appropriate government bodies would create rules and regulations necessary to fully articulate and properly implement rules and procedures for differentiating between NPOs and FPOs.

The recommended definition of an NPO, especially the fourth element of it, places great emphasis on the "non-distribution constraint" – the fundamental principle that distinguishes for-profit from not-for-profit organizations. Under this principle, an NPO is precluded from distributing any profits, assets, or earnings to anyone except pursuant to its not-for-profit purposes. The proposed definition, in other words, gives full force and effect to the first principle stated above for distinguishing between for-profit and not-for-profit organizations.

3.2.2 Definition of PBO -- MOCA, MOF, and SAT should develop rules and regulations clarifying that a PBO is (1) an NPO that (2) that is organized and operated exclusively for public benefit purposes by (3) engaging public benefit activities that (4) benefit (a) all members of the community or (b) some particular group that is disadvantaged or otherwise deserving of special benefits.

Rationale: Drawing a clear line of demarcation between NPOs and PBOs will be important for determining eligibility for various tax benefits. PBOs will be accorded the highest level of tax benefits while NPOs will receive only certain benefits. The distinction is also important under the principle of uniformity – all PBOs should be subject to the same rules whether they are organized as SOs, foundations, or *minban fei qiye danwei*.[115] In addition, in order to eliminate the possibility of tax evasion through the choice of particular legal form. tax rules should apply to all other NPOs in a uniform manner.

A PBO should be defined as follows: (1) an NPO as defined in Recommendation 1.1, (2) that is organized and operated exclusively for public benefit purposes (3) by engaging in public benefit activities that (4) benefit (a) all members of the community or (b) some particular group that is disadvantaged or otherwise deserving of special treatment. MOCA, MOF, and STA should develop rules and regulations that more fully articulating these concepts and applying them to practical realities in China. Appendix H, setting forth the Model Provisions for Laws Affecting PBOs, contains a useful and proven set of rules for making this differentiation. Those rules are incorporated by reference here.

The non-distribution constraint – explained under Recommendation 1.1 above – applies with special force in the case of a PBO. A PBO, like an NPO, cannot distribute its profits, assets, or earnings other than in fulfillment of its not-for-profit purposes. In the case of an NPO, however, this perm it's the provision of benefits to members, such as when a professional association provides special education or advantageous life insurance programs to its members. A PBO, however, must devote its assets exclusively to public benefit purposes. The assets of a PBO become, in other words, "charitable assets," which can be spent or used only for charitable or public benefit purposes.

3.2.3 <u>Definition of Public Benefit Activities</u> -- In light of Chinese traditions and current needs and priorities, China should carefully define as "public benefit activities" those types of activities that the State regards as having the highest value for society when carried out by the collective action of citizens.

<u>Rationale.</u> Each country must define "public benefit activities" in the way most suitable for its traditions and needs. Among those activities considered by many countries to constitute public benefit activities are the following: (1) the prevention and relief of poverty, (2) the advancement of education or spiritual well being, (3) the treatment of illness, accident, or disability, (4) the advancement of health, (5) social and community advancement, (6) the advancement of amateur sport, (7) the promotion of civic rights, conflict resolution, and reconciliation, and (8) the advancement of environmental protection and improvement. A longer list that may be helpful in developing a definition of public benefit activities for China can be found in Appendix H.

3.2.4 <u>Enterprise Income Tax</u> -- NPOs and PBOs should be exempt from the Enterprise Income Tax (EIT) according to the following rules:

1) <u>PBOs</u>

- **should be exempt from EIT on all their net profits from gifts, grants, and membership dues;**

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[115] This recommendation assumes that all privately-run, non-enterprise units (*minban fei qiye danwei*) are made subject to the non-distribution constraint.

- **should be exempt from EIT on all their net profits from investments (i.e., dividends, interest, rents, royalties, and capital gains);**
- **should be exempt from EIT on all their net profits from related business activities; and**
- **should be subject to EIT on net profits from unrelated business activities.**

2) <u>NPOs</u>

- **should be exempt from EIT on all their income from gifts, grants, and membership dues; and**
- **should be subject to EIT on net profits from all other sources.**

<u>Rationale</u>: Exemption from the EIT is significant for NPOs because they will typically have revenues from a variety of sources, including the following:

- gifts, grants, membership dues;
- investment activities (income from stocks, bonds, bank accounts, rents, royalties, and capital gains);
- trade or business activities that are related to and that further their public benefit purposes (such as sales of goods or services related to the organization's not-for-profit purposes); and
- unrelated trade or business activities (such as commercial activities or sales of goods or services to non-members) the profits from which support their not-for-profit purposes.

For all kinds of NPOs, income from gifts, grants and membership dues should be permitted to be received without tax. As a matter of good international practice, exemplified in particular by countries with a well developed third sector, these sources of income are typically exempt from the income or profits tax. As to other sources of income, however, a distinction should be made between PBOs and all other NPOs. Although NPOs that serve their members enhance civil society, they do not directly serve public benefit purposes. It is consistent with international good practice to subject them to tax on a variety of sources of income. Accordingly, PBOs should be subject to tax only on net profits from unrelated trade or business activities, while other NPOs should be subject to tax on net profits from any investments or business activities.

Creating rules that differentiate between NPOs and PBOs and that apply uniformly to all PBOs, on the one hand, and all NPOs, on the other, is crucial for ensuring that those organizations that truly benefit society receive the highest level of tax exemptions and preferences and that the rules are seen as a rational and consistent whole.

3.2.5 <u>Distinction Between Related and Unrelated Business Activities</u> -- MOCA, MOF, and SAT should develop rules and regulations for distinguishing between related and unrelated business activities of PBOs.

<u>Rationale</u>: Taxing PBOs only on unrelated trade or business income while exempting them on related trade or business and investment income (as under 1.4) makes it necessary to create rules

for differentiating between related and unrelated trade or business activities. This is particularly important because many PBOs charge fees for the goods and services they provide in connection with their public benefit activities. For example, if, in order to recover its costs, a medical clinic charges fees to patients who can afford to pay them, while providing free medical services to the poor, providing medical services for a fee should be considered to be a "related" business activity. Further, if a private school or university grants scholarships to poor students but charges tuition fees for the students who can afford to pay, such fees should be considered income from a "related" business activity.

On the other hand, if the medical clinic that charges fees to patients who can afford to pay also runs a pharmacy that makes a profit selling drugs to the general public, or if the university that charges tuition also operates a store that sells computers and peripherals to the general public for a profit, these should be considered "unrelated" business activities. Moreover, such profits are "unrelated" even if they are used to support the university' educational purposes. Under the proposed rule, these profits from the unrelated business activities of a PBO would be subject to EIT.

Turning to investment income, PBOs often make investments in stocks or bonds, and hold minority ownership interests in profit-making enterprises, or simply place funds that are not immediately needed in interest-bearing bank accounts. Investments such as these are made with the PBO's endowment or financial reserves, which are generally crucial to their survival. These investment activities generate "passive" income (.i.e., dividends, interest, rents, royalties, and capital gains). They should not be regarded as income from an active trade or business, and, consistent with the practice of countries with a well-developed third sector, they should not be subject to the EIT.

Finally, many PBOs engage in activities to raise money for the organization, such as, raffles, charity auctions, and so forth. These fund-raising activities should not be regarded as active trade or business activities. An active trade or business is one that is conducted on a regular and continuing basis and one in which the PBO plays a major management role. Thus, just as income for occasional fun-raising events is not income from an active trade or business, neither is rental income from a building owned by the PBO and leased to other organizations.

Each of the above issues, and others as well, must be addressed in the rules and regulations that are issued by MOCA, MOF, and SAT. Further discussion of how to distinguish between related and unrelated business activities can be found in Part II and in Appendix F.

3.2.6 Business Tax and Value Added Tax –Business Tax exemption and VAT rebate for NPOs. PBOs should be exempt from Business Tax. Rebate for VAT should be provided for PBOs. No exemption or rebate should be provided for NPOs that are not PBOs.

Rationale: PBOs should be exempt from Business Tax. PBOs that have paid significant amounts of net annual VAT for goods or services used by it in connection with its public benefit purposes should be allowed to file annually with the tax authorities for a refund of some or all of the net amount of VAT.

Value added and business taxes represent the single largest tax burden that is borne by PBOs in China today. Zero-rating of PBO outputs benefits only PBOs that sell goods subject to VAT or services subject to the Business Tax, and VAT exemptions are largely ineffective, because they tend to cause sellers to raise prices to make up for the lost deduction or rebate for taxes on outputs. Permitting PBOs to obtain a refund of at least some portion (e.g., 50%) of the net amount of VAT and exempt them from Business Tax, so long as it is above a reasonable threshold level (e.g., RMB 25,000), will do much to alleviate these heavy tax burdens on PBOs without creating rules that are difficult to administer or open to abuse.

3.2.7 <u>Customs Duties and Import VAT</u> -- All PBOs should be allowed exemption from customs duties and import value added tax (VAT) on goods imported for use or consumption in connection with their public benefit activities. No exemption should be allowed for goods imported by NPOs that are not PBOs or for the non public benefit activities of PBOs.

<u>Rationale:</u> Many foreign bilateral and multilateral donors refuse to have customs duties or import VAT imposed on goods, equipment, and supplies they import for their own use or that are imported by or for foreign or domestic PBOs to carry out projects funded by these donors. As a result, either by law or special treaty or agreement, most recipient countries exempt such imports from both customs duties and import VAT.

Consistent with the principle of equal treatment, the tax laws should be amended to put all PBOs on an equal footing by exempting all goods imported by PBOs for their public benefit activities from customs duties and import VAT. To obtain and retain this exemption, a PBO should be required to present proof that it is certified as a PBO, and it should be required to file reports in each of the next three years certifying that they have either consumed the exempted goods in the course of their public benefit activities or that the goods are still being used exclusively in connection with those activities. If the PBO sells or otherwise disposes of the goods or equipment (e.g., a vehicle) prior to the end of three years, it would have to pay both customs duty and import VAT on the original value.

3.2.8 <u>Real Estate Tax</u> -- All PBOs should be exempt from the Real Estate Tax (RET); NPOs should pay one-half of the tax that would otherwise be due. All real property of both PBOs and NPOs that is used for profit-making purposes, such as rental, should be fully subject to the RET.

<u>Rationale</u>: At present, all NPOs in China are entitled to exemption from real estate tax. This is overly generous and is not consistent with the prevailing practices in other countries. This recommendation would limit exemptions under the RPT by basing them on the type of NPO that owns the property and the use of the property; it is consistent with good practices in other countries.

3.2.9 <u>Vehicle and Vessel Usage Tax</u> – All PBOs should be exempt from these taxes; NPOs should pay one-half of the taxes that would otherwise be due.

<u>Rationale</u>: Exemptions from Vehicle and Vessel Usage Tax should be applicable to vehicles held by PBOs for use in connection with their public benefit activities, no matter what class of vehicle is involved. For NPOs, the exemption should be limited to one-half of the amount of tax.

These proposals clarify the proper treatment in accordance with the type of NPO and the usage of the property; they are consistent with good practices in other countries.

3.2.10 <u>Farm Land Occupation Tax</u> --There should be no exemption from this tax for any NPOs, not even PBOs.

<u>Rationale</u>: The Farm Land Occupation Tax is imposed on the occupation of farmland for non-farming usages, and its aim is to protect the natural resource of farm land. The general guideline for the reform of the Farm Land Occupation Tax is that any unit that has occupied farm land should be subject to Farm Land Occupation Tax. At present, however, China's policies for NPOs with regard to Farm Land Occupation Tax are quite preferential -- all NPOs are exempt from this tax. Since China is running out of farmland for agricultural purposes, it should impose Farm Land Occupation Tax on all organizations and individuals that occupy farmland for non-agricultural purposes. Exempting NPOs from this tax is not consistent with the purpose of the tax or the future development of China.

3.2.11 <u>Urban and Township Land Usage Tax, and Deed Tax</u> -- All PBOs should be exempt from these taxes; NPOs should pay one-half of the taxes that would otherwise be due.

<u>Rationale</u>: According to the principles for the reform of the tax system, PBOs should continue to enjoy exemptions from the Urban and Township Land Usage Tax, and the Deed Tax. Non-PBOs should pay only half of the tax due. If an NPO own a piece of land that is used for profit-making activities, the named taxes should be imposed in accordance with relevant tax laws and regulations.

3.2.12 <u>Stamp Tax</u> – There should be no exemption from this tax for any NPOs, not even PBOs.

<u>Rationale</u>: The amount of Stamp Tax imposed on various NPOs depends on the different taxable items, such as contracts, accounts, etc. It is a minor tax, and the tax rate for it is quite low. Consequently, the amount of the tax is not large enough to become a burden for NPOs, and creating exemptions would complicate administration of the tax.

3.2.13 <u>Limitation on Business Activities</u>. The law and the rules adopted by MOCA, MOF, and SAT should make it clear that a PBO must be devoted exclusively to one or more public benefit activities. A PBO may engage in business activities that are related to its public benefit purposes, but unrelated activities, including unrelated business activities, may not constitute more than an insubstantial part of the activities of the PBO. The rules should also make it clear that there can be no direct or indirect distribution of profits to anyone at any time, including at termination.

<u>Rationale</u>: Like other NPOs, in order to survive PBOs may need to conduct business activities to support their public benefit activities. This is especially true in a developing country such as China, which does not have a strong tradition of charitable giving. For example, a sailing club might provide sailing lessons for a fee to non-members in order to support its services for

members. Such unrelated activities are permissible for an NPO that is not a PBO, so long as they do not constitute the principal activities of the organization (i.e., more than 50%). In the case of a PBO, however, unrelated activities, including unrelated business activities, may not constitute more than an insubstantial (5%?) amount of the activities of the organization. Whether a particular sailing club is an NPO or a PBO will depend upon its purposes (e.g., promotion of amateur sports as opposed to a social club) and other relevant facts and circumstances.

Despite the strict limit that should be imposed on the unrelated business activities of a PBO, it may well be that a particular PBO can best carry out its public benefit purposes by conducting a related business activity (such as publishing a magazine about art or culture). There need not be any limitation on the extent to which a PBO engages in related business activities (e.g., a museum that charges an entrance fee to all visitors).

Further, although NPOs are subject to the non-distribution constraint, and PBOs must comply with all rules for being an NPO, for purposes of education and emphasis it is appropriate for the law and relevant rules to emphasize that a PBO may not distribute profits, earnings, or assets either directly or indirectly to anyone at any time except in fulfillment of its public benefit purposes. Finally, as stated in Recommendation 1.4, any net profits from unrelated business activities of a PBO should be subject to the Enterprise Income Tax. All net business profits of an NPO, whether related or unrelated, should be subject to the EIT.

3.2.14 <u>Uniformity of Tax Preferences for Donations</u> -- The percentage limitations for donations made by domestic and foreign enterprise should be made uniform. Thus, under the Income Tax for Foreign-funded and Foreign Enterprises, foreign enterprises should be subject to the same percentage limitation on public welfare donations that apply to domestic enterprises under the EIT.

<u>Rationale</u>: This proposal is consistent with the principle of equal treatment and involves similar treatment for similarly situated enterprises. There is no good reason for there to be a difference between foreign and domestic enterprises in terms of the percentage limits on public welfare donations. Under Recommendation 1.17, the proposed limit for both would be 10%.

3.2.15 <u>Amount of Tax Preferences for Donations</u> -- Tax preferences for deductions should be limited to donations to PBOs, and the percentage limitations on public benefit donations contained in the Individual Income Tax Law and the Provisional Regulations on the Enterprise Income Tax should be increased to:

- **10% for enterprises (up from 3%) and**
- **50% for individuals (up from 30%).**

<u>Rationale</u>: Tax preferences for donations should be both restricted and expanded. First, no deduction should be allowed for any donation to an NPO that does not qualify as a PBO, because, by definition, they are not providing a public benefit. It is in China's interest, however, to increase the percentage limits for donations to PBOs. With respect to enterprises, although 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. For example, a business might donate a building to a PBO for use as a school or medical clinic.

As to individuals, they do not have the same constraint to maximize value for shareholders that business enterprises have. Accordingly, individuals can be more generous in making donations for public benefit, and they should be allowed and encouraged to do so. If there were no limit on allowable deductions to PBOs, however, it would be possible for a wealthy individual to avoid paying any taxes at all by contributing to PBOs an amount equal to his taxable income each year. All citizens should support Chinese society, however, and it is therefore appropriate that each citizen bear a fair share of the costs of government if he is financially able to do so.

Increasing the allowed deduction percentages will encourage both wealthy individuals and enterprises to donate a greater percentage of their annual incomes for public benefit purposes, which will advance social and economic development in China. The proposed percentage limits are the same as those imposed in the United States, but they are more stringent than the law in Australia, which imposes no limits whatsoever for individuals.

3.2.16 <u>In-Kind Donations</u> -- Deductions for gifts in kind (property) to PBOs should be allowed, but, in the case of property for which there is not a readily ascertainable fair market value, only if the donation is approved in advance by SAT or its branches.

<u>Rationale</u>: Although it is desirable that tax benefits be provided to encourage the donation of valuable assets (e.g., buildings, land, shares of stock, or rare works of art) to PBOs, the experience of other countries is that these kinds of donations may be abused by unscrupulous taxpayers who overstate the value of what they contribute. This is not a problem with respect to property for which there is a readily obtainable fair market value, such as the share value of publicly traded securities. However, donations of property without a readily ascertainable fair market value should be permitted to be deducted only with the advance approval and a written agreement as to value from the SAT. Depending on the particular case, such an agreement could be based on a valuation by an independent appraiser or on contemporaneous sales of similar property.[116]

3.2.17 <u>Carry-forwards</u> -- Individuals and enterprises should be allowed to carry forward and claim in the next year any charitable contribution deductions that exceed the annual percentage limitation allowable for the current year.

<u>Rationale</u>: Allowing carry-forwards of unused but otherwise allowable charitable deductions solves practical problems without increasing the amount or timing of permitted deductible contributions to PBOs. For example, a taxpayer might want to make a particularly large contribution to a PBO all in one year, rather than spreading it over several years, because of an urgent need of the PBO or to avoid artificially breaking up a single piece of property. Thus, if an individual wanted to give a block of publicly traded shares of stock or a building to a PBO and the donation was equal to 100% of his income, without a carry-forward provision he would have

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116 Recent changes in the law in the United States impose strict new appraisal requirements on in-kind donations. See discussions in the October 2004 issue of IJCSL, available at www.law.cua.edu/students/orgs/IJCSL/.

to give one-half of the property this year and the other half next year. If carry-forwards were permitted, however, he could give the entire amount of stock or the entire building in the first year. He would be allowed to deduct half of the value in the year of donation and the other half in the subsequent year. The tax advantage to him is the same in either case, because a carryover deduction, which reduces taxes only with respect to a subsequent year, is worth less than a current deduction, due to the time value of money.

3.2.18 Allow Direct Deductible Contributions -- The tax laws should permit deductible donations to be made directly to all certified PBOs rather than only through certain listed organizations, as is currently the case.

Rationale: The current system[117] under which deductible donations can be made only to a select list of organizations should be changed so that all certified PBOs are permissible recipients of tax deductible contributions. The current system is premised on the need for additional oversight of organizations that receive tax-preferred donations under the Public Benefit Donations Law, but that oversight can be more appropriately performed by the government under well crafted laws and regulations, such as those recommended in this Report. By requiring that competent business units or large NPOs act as conduits for donations made to others, the law has imposed an additional, unnecessary, and costly administratively burden and a rent-seeking opportunity, which can be eliminated.

3.2.19 Adopt a Tax Designation Scheme -- A "tax designation scheme" should be developed under which, in addition to allowing deductions for contributions to PBOs, an individual would be allowed to designate that 1-2% of his taxes be paid over by the tax authorities to a PBO designated by him. Development of this scheme will take time, but a decision to adopt such a scheme could be made now.

Rationale: As has been made clear in other parts of this Report, there is a great and growing need in China to encourage the provision of more resources to PBOs so that they can take over more activities that have previously been provided by the State. Without reducing the amount of taxes owed by individuals, a tax designation system allows individuals to direct a small portion of their taxes to public benefit purposes selected by them and approved by the State. Because contribution amounts flow through the hands of the tax authorities, fraud is eliminated.

A tax designation scheme would strengthen the solidarity of Chinese society by encouraging all citizens to make contributions for public benefit purposes. Currently, only taxpayers who have large incomes file tax returns on which they can claim deductions for donations to PBOs. Most Chinese citizens, however, pay their taxes entirely through withholding by the employer. Without reducing overall tax revenues, a tax designation scheme allows even these citizens to contribute to public benefit activities that have been approved by the State. Moreover, by giving each taxpayer control over the use of a small portion of his taxes, a tax designation scheme increases the feeling of each taxpayer that he is participating directly in building and strengthening Chinese society.

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[117] See supra note 9.

3. Procedural Recommendations

At present the SAT administers the tax system for NPOs in the same manner as it does for corporate legal persons. This is in accordance with the *Tax Collection and Administration Law* and the corresponding detailed rules for implementation and other relevant laws and regulations, which do not provide any special rules for NPOs. Thus, all NPOs must follow all the tax rules that apply to business enterprises, including the relevant rules for tax filings. In addition, the format of the tax returns and the items that are to be included in tax returns for NPOs are the same as those for tax returns used by enterprises. This practice adds to the difficulty and expense for NPOs in meeting their tax obligations. There should be a special system for tax administration for NPOs, a system that is different from the system for corporate enterprises and is tailored for the special characteristics and the actual conditions of NPOs. Such a system would increase the effectiveness of tax compliance by NPOs and oversight by the tax authorities while decreasing the burdens and costs to NPOs.

3.2.20 <u>Receipt for Donations</u> -- A special form of receipt should be designed by SAT to be used specifically for donations to PBOs. An individual or enterprise should not be allowed to take a deduction for a donation unless the individual or enterprise has a receipt issued by the PBO to verify the contribution.

<u>Rationale:</u> NPOs at present do not have special receipts to document donations from donors. Some NPOs are using receipts printed by the financial departments of the various localities, and some NPOs do not even issue any receipts for donations. These practices make it difficult to standardize the operations of NPOs with respect to donations, and they also make it difficult for enterprises or individuals that make the donations to verify their donations and thereby obtain the proper deductions from taxable income. Requiring a prescribed form of receipt for every deduction that is claimed for a donation to a PBO is consistent with good practices in other countries and regions of the world.

3.2.21 <u>NPO and PBO Tax Forms</u> -- Special tax forms tailored to meet the needs and special characteristics of NPOs and PBOs should be designed by SAT for both registration and tax filings. Developing these new forms will take time, but work on them could begin now.

<u>Rationale:</u> At the present time, NPOs are required to use the same registration forms and the same tax filing forms as enterprises. The contents and format of both the registration and tax filing forms are based on features of the business operations of enterprises, and they do not reflect the special characteristics and activities of NPOs and PBOs. In addition, the current forms are not designed to differentiate between the purpose-related activities of NPOs and PBOs and any business operations they may have. Consistent with the recommendations in this Report, the forms should reflect that NPOs should be taxed on all profits from investment activities and from business activities, whether related or not, whereas PBOs should be taxed only on profits from unrelated business activities.

Special tax registration and tax filing forms should be designed to reflect the special nature and operation of NPOs, and they should be implemented as soon as possible. Doing so will simplify and expedite the registration and filing requirements not only for the benefit of NPOs, but also for the benefit of the tax administration officials dealing with NPOs. Although the annual reporting requirements for NPOs can be quite simple, PBOs should be required to file detailed financial and activity reports and provide sufficient information to enable SAT to determine whether they are in compliance with all legal requirements. Registration and reporting requirements, forms, and procedures that are designed specifically for NPOs and PBOs will make law enforcement both more effective and easier.

3.2.22 <u>NPO Accounting Standards</u> -- A new financial accounting system tailored to meet the needs and special characteristics of NPOs and PBOs should be developed.

<u>Rationale</u>: It has been said that MOF and SAT are developing a special set of accounting rules for NPOs. This new accounting system should be adopted and standardized for all NPOs as soon as possible.[118] The current accounting system for NPOs in China was designed for business enterprises and does not recognize the special nature and characteristics of NPOs. As other countries have discovered, it is necessary to adapt the accounting rules that apply to enterprises to fit the special circumstances of NPOs. Failure to do so may impede the healthy development of NPOs and make the enforcement of appropriate laws and regulations more difficult. [119]

3.2.23 <u>Rules for Record-Keeping and Retention</u> -- Record-keeping and record retention rules should be adopted for NPOs and PBOs.

<u>Rationale</u>: Without clear rules specifying how and the extent to which PBOs and NPOs must keep books and records, they sometimes fail to do so adequately. It is especially crucial for adequate PBO oversight by SAT and for adequate internal oversight of NPOs that adequate and appropriate books and records be maintained and be available to SAT, members, and boards of directors. In addition, there should be clear rules specifying the length of time various kinds of records and documents (such as minutes of AGMs, accounting records, etc.) must be retained. These rules should not require organizations to retain all records forever, but they should assure that enough documents and records are retained long enough to make effective law enforcement and self governance effective.

3.2.24 <u>Annual Reports</u> -- Annual financial and activity reports should be required for all but the smallest of PBOs; certified audits should be required for large PBOs. NPOs and PBOs with income above a specified threshold should be required to file reports at least annually with the tax authorities.

<u>Rationale</u>: All but the smallest PBOs should be required to file an annual report of finances and activities. Although every NPO and every PBO should be required to maintain adequate books and records, there is no need for NPOs to file reports unless they have more than a threshold

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[118] One source to look to for guidance in this regard is the new accounting system adopted for NPOs in Switzerland. See Kaspar Müller, *Swiss GAAP FER 21 Accounting Standard for Charitable, Social Non-Profit Organizations*, in 1 INTL J. OF CIVIL SOC. L. 27 (October 2003), available at www.law.cua.edu/students/orgs/ijcsl/.

[119] When this report is being completed, a new Accounting System for Private Non-Profit Organizations was issued and went into effect on January 1, 2005.

amount of taxable income, and then only reports relevant for tax purposes need to be filed. Small PBOs (e.g., turnover of less that RMB 50,000) should be exempted from filing annual reports. Medium sized PBOs (e.g., between RMB 50,000 and 1,000,000) should be required to file annual financial and activity reports. Large PBOs (e.g., turnover of more than RMB 1,000,000) should in addition be required to have their financial statements audited by an independent certified public accountant. The SAT should use these reports, and other reliable information that comes to it, as the basis for examinations and audits of PBO activities.

Reporting is the basic tool for assuring transparency and accountability for PBOs. It is important that the SAT have staff with the training and sophistication to be able to read annual reports effectively and to follow up on them as needed.

3.2.25 <u>Public Reports</u> -- Every PBO that is required to file an annual report with the SAT should be required to make those reports public. Confidential information and trade secrets may be omitted from the public reports. Reports by NPOs do not need to be made public.

<u>Rationale</u>: The proper operation of PBOs is particularly important because (a) they affect the public interest through their activities, and (b) they receive significant tax benefits. In order to assure that the PBO sector meets public needs and to give the public confidence that particular PBOs are being run effectively and without corruption, PBO reports should be publicly available. The PBO should be allowed to redact confidential information or trade secrets. The reports should be made available in a public reading room at the STA, and any member of the public should be allowed to look at the reports on the premises of the PBO and to request a copy of all or part of a report for no more than a reasonable copying charge. In addition, annual financial and activity reports should be available to anyone at the headquarters of each PBO and copies of all or part of them should be available for no more than a reasonable copying charge. A PBO can satisfy this requirement by posting its reports on its website in a downloadable format.

Because NPOs that are not PBOs do not affect the public interest in significant ways, or receive significant tax benefits, any annual reports filed by NPOs should not be required to be made publicly available.

3.2.26 <u>Governance</u> -- Strong fiduciary duty, conflict of interest, and self-dealing rules should be adopted for both NPOs and PBOs. Good examples of such rules can be found in Appendix H, setting forth the Model Provisions for Laws Affecting PBOs.

<u>Rationale</u>: The law needs to impose high standards of conduct on NPOs and PBOs and the people who run them. Officers, board members, and employees of an NPO or a PBO should not be liable in their individual capacity for the debts, liabilities, or other obligations of the organization, but they should be liable to the organization and/or to injured third parties for willful conduct or grossly negligent performance or omission of their duties. Officers, board members, and employees of an NPO or a PBO should have a duty, required by law, to exercise loyalty to the organization, to execute their responsibilities to the organization with care and diligence, and to maintain the confidentiality of non-public information about the organization.

Officers, board members, and employees of an NPO or a PBO should be required to avoid any actual or potential conflict between their personal or business interests and the interests of the organization. Any actual or potential conflict of interest should be disclosed to the governing body of the organization. It is generally appropriate for an organization to require a person with a conflict of interest to disclose it and then to recuse (absent) himself from the discussion of and decision-making about the relevant issues. For example, if an individual who sits on the board of a PBO is also an officer of a local bank, the individual should be required to recuse himself from any decisions by the organization about where it should establish its banking business or obtain a loan.

A conflict of interest transaction may be authorized or approved if a majority of disinterested directors agree to waive the conflict of interest. As a matter of good practice, the waiver should be made in advance and a majority of the entire board of directors should agree to the waiver. This would be appropriate, for example, where the organization stands to benefit from the proposed transaction, such as where a director proposes to lease office space to the organization at a less than fair market rent. More generally, any financial transaction directly or indirectly between a civic organization and one or more of its officers, board members, or employees must be concluded on terms that, from the perspective of the organization, are equal to or better than fair market value terms.

A PBO should be prohibited from providing special personal benefits, directly or indirectly (e.g., scholarships for relatives), to any person connected with the organization (e.g., founder, officer, board member, employee, or donor). No PBO should be permitted to distribute assets to its founders, officers, board members, employees, donors, or members upon its liquidation. Benefits may be made available to members of an NPO if they are made available on a nondiscriminatory basis to all members (e.g., special educational materials or life insurance plans).

Consideration should be given to adopting the conflict of interest rules in the Model PBO Provisions (Appendix H to this Report) or to simplified versions of Sections 4941 (self-dealing) and 4958 (excess benefits) of the U.S. Internal Revenue Code.

3.2.27 <u>Code of Conduct</u> -- In order to acquire and retain status as a PBO, an organization must agree to and follow all of the terms, conditions, and procedures of a Code of Conduct to be drafted by PBOs and enforced by the PBC.

<u>Rationale.</u> PBOs receive the highest level of tax benefits and their activities affect the public interest. They should be required to adopt and follow the highest standards with respect to ethical conduct, transparency, accountability, fair dealing, and good governance. These standards should be stated in a Code of Conduct which is developed and agreed to by an open process in which all certified PBOs may participate. Because the standards will be developed by the PBOs themselves, it will respond to the real world needs and situations of PBOs. For example, some requirements may be appropriate only after a PBO has reached a certain size.

The drafting of the Code of Conduct should begin no later than six months after the law establishing a procedure for certifying PBOs has entered into force, and the initial Code should be completed within two years of that date. All certified PBOs should be entitled to participate in the process of developing the Code of Conduct. The PBC should have no vote or veto with respect to the content of the Code of Conduct, but it may facilitate the process, participate in the discussions, and provide technical assistance. When the PBC is satisfied that the draft Code of Conduct has been developed by a fair, open, and transparent process, it will put the Code into effect and enforce it. The Code of Conduct should be reviewed every two or three years by an open process in which all PBOs may participate, and amended as appropriate.

PBOs will be required to certify annually that they are in full compliance with the Code of Conduct. The PBC may conduct inquiries or investigations to determine the extent of PBO compliance. If a PBO is not in compliance with one or more of the requirements of the Code of Conduct, it will be notified and given a reasonable period of time in which to comply. If it fails to achieve and maintain compliance, it may be decertified and lose its status as a PBO.

3.2.28 <u>Compensation Limits</u> -- Compensation limits should be imposed on PBOs, by requiring them to adopt a salary scale no greater than that of universities or of the government.

<u>Rationale</u>: Although individuals who decide to devote their lives to public benefit activities should not be prevented from receiving reasonable compensation, it is important to place limits on compensation to assure the public that PBOs are not devices for personal enrichment. In order to insure that PBOs do not become tools for unjust enrichment of a few individuals, rules should be adopted restricting the compensation of each individual working for a PBO to no more than that for the appropriate level of compensation provided for similar work in the government or in a university. "Compensation" should be defined to include cars, houses, or any in-kind benefit of primarily personal value to the individual. The SAT or other appropriate governmental agency should provide all PBOs with information on relevant salary scales.

This restriction on compensation does not need to be imposed on NPOs, which by definition do not affect the public interest and, under the recommendations in this Report, would not receive significant tax benefits.

3.2.29 <u>Registration</u> -- The formalities for tax registration should be simplified for NPOs.

- Tax registration for NPOs that are not PBOs should be carried out under a simplified procedure.
- Tax registration for PBOs should require additional scrutiny by SAT and its branches of their purposes and proposed activities, but the procedure should be structured so as not to impose unnecessary burdens.

<u>Rationale</u>: In order to strengthen supervision and control over them, China currently has a system of dual registration for NPOs. Thus, the contents of their activities and the way in which the activities are conducted are required to be first vetted by the relevant competent business unit (CBU) and then reviewed by MOCA prior to registration. In addition, when NPOs go through the formalities for tax registration, the tax authorities require that NPOs provide it with the approvals obtained from and documents submitted to the CBU and MOCA, which are once again reviewed. This requirement in effect establishes a third procedure of examination and approval, which adds to the difficulty and burden for tax authorities in the administration of the system, as well as increasing the administrative burdens on NPOs.

Under the recommendations in this Report, the procedures for tax registration should be simplified for NPOs. Simplified tax registration for NPOs would involve a certification from MOCA and the CBU that the NPO has met the requirements for registration as a juridical person. The simplified procedures can be enforced by having an NPO fill out a short application form, with the proper certifications attached, which should be processed expeditiously by the tax authorities.

On the other hand, PBOs are properly the recipients of special tax preferences as outlined above in the Substantive Recommendations. As such, greater scrutiny of their proposed activities by the SAT at the time of registration is appropriate. The importance of preventing tax abuse should be the paramount concern. MOCA and SAT should strive to keep their forms similar and to not require that unnecessary or unduly burdensome filings be required for PBO status.

3.2.30 <u>Oversight</u> -- Procedures for the oversight by SAT of PBOs with special tax preferences should be strengthened.

<u>Rationale</u>: As discussed in Parts I and II, the nature of an NPO, and particularly a PBO, is different from that of a for-profit enterprise. Two fundamental distinctions are (1) that an NPO does not have owners and (2) that an NPO is not subject to the discipline of the market with respect to the goods and services it provides. The forms of oversight of NPOs that are used in other countries take these two distinctions into account in establishing the rules for accountability of NPOs and for their transparency to the general public, and China should adopt a similar approach.

The rules in other countries also tend to provide significant differences in the oversight of PBOs as opposed to NPOs. While it is necessary to continue to ensure that NPOs do not become confused with for-profit businesses (consistent with Principle 1 and Substantive Recommendation 1.1 above), significant tax benefits are granted only to PBOs, and the oversight of them by SAT should be proportionately greater.

3.2.31 <u>Sanctions</u> -- Special administrative sanctions should be imposed on PBOs that violate the new rules applicable to their records, reports, activities, etc.

<u>Rationale</u>: Because the current civil and criminal penalties provided for in Chinese law are inadequate to deal with special legal rules that would be applicable to them under the recommendations in this Report, it will be necessary to create a special legal sanctions regime for PBOs. One recent source of information about such a sanctions regime can be found in *Canada Country Report -- Budget Proposals to Make Major Revisions in Law Affecting Charities and NPOs.*[120]

3.2.32 <u>Public Benefit Commission (PBC)</u> – A PBC should be created, with representatives from the Prime Minister Office, MOCA, MOF, PBOs, and the public. It should be responsible for registration, oversight, and regulation of PBOs. Appendix H, setting forth

[120] This is available in 2 INTL J. OF CIVIL SOC. L. 131 (April 2004), available at www.law.cua.edu/students/orgs/ijcsl/.

Model Provisions for Laws Affecting PBOs, contains many of the rules, principles, and procedures that should govern a PBC.

- The PBC should be established as an autonomous organ of the government.
- The PBC should have the power and responsibility to certify PBOs; to exercise oversight of PBOs; to apply administrative sanctions to PBOs that violate their duties as established by law or their charters; and to de-certify PBOs when appropriate.
- The PBC and MOCA should maintain a website with a list of all certified PBOs. This website should be kept up to date on a weekly basis. In addition, the PBC should publish a hardcopy list of certified PBOs at least annually
- Consistent with conferring these powers and responsibilities on the PBC and the development of an expert staff at the PBC, the role of the competent business units (CBUs) in the establishment, oversight, and management of PBOs should be reduced or eliminated.

Development of a PBC will take time, but the publication of a list of certified PBOs should be initiated as soon as possible.

Rationale: In Part II there is lengthy discussion of the advantages of a Public Benefit Commission, which is charged with the responsibility to certify PBOs, oversee the activities of PBOs, and ensure that these activities conform to the requirements for giving them preferred tax status.[121] This recommendation is consistent with the Charity Commission of England and Wales, which was established to carry out such oversight many years ago. Similar commissions have been adopted (with greater or lesser success) in Brazil, Italy, Russia, and Moldova; currently, both New Zealand and Scotland are in the process of creating similar commissions.

Participants in the two conferences held in Beijing and Shenzhen in May 2004 were generally favorable to the idea of creating such a commission for China, though there were some dissenting voices. Although there should be ample opportunity for full debate and consideration of the issues involved in the creation of such a commission, this Report recommends the creation of a PBC for China and outlines the manner of its functioning.

This new institution should have the authority and responsibility to certify and decertify PBOs, to oversee them, review the annual reports on their activities and finances, and issue regulations, rulings, instructions, and model documents to guide the establishment and operation of PBOs. It should replace the cumbersome three-step registration process described above, under Recommendation 1.27. The PBC should have five commissioners, one appointed by each of the Ministries of Finance and Civil Affairs, one appointed by the Prime Minister, one appointed to represent PBOs, and one to represent the public. The PBC should have a separate staff and budget.

A PBC will provide expert and effective administration of the laws regulating PBOs. It will have representation from key government ministries, which will have the majority of seats, and representation by the public and PBOs will create trust and assure evenhandedness. See the discussion in Part II. Provisions much like the Model PBO Provisions in Appendix H would be appropriate for the establishment of the PBOC.

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[121] See text supra at note 109.

A principal reason to establish a PBC is to develop expertise and competence in dealing with PBOs in one agency. The responsibility for oversight and regulation of PBOs should be done by the PBC, with whatever assistance and advice it may seek from the competent business unit. CBUs, however, have many other tasks to perform and no particular expertise in dealing with PBOs. Although it might be appropriate initially to have the non-binding recommendation of a CBU prior to allowing the certification of any PBO, over time the PBC will acquire adequate expertise so that the role of the CBU can become one of offering advice on request.

A procedure should be established to permit any NPO to apply for certification as a PBO provided it satisfies each of the four criteria set out in the definition of PBO (in Principle 2 and Substantive Recommendation 1.2, above) and is organized and operated exclusively to provide public benefit by engaging in one or more of the nine categories of public benefit activities set out in Recommendation 1.3. A new NPO should be entitled to tentative PBO status if its documents and plan of work are consistent with the PBO requirements, but the PBC should conduct a special examination after three years to ascertain that the organization has been operated in accordance with the PBO rules. If it has not, it would be stripped of PBO status (though no deductions for previous donations to it would be revoked).

If any PBO fails to carry out its purposes and activities in accordance with the law, the PBC should be able to de-certify it, after notice to the PBO and opportunity to correct the failure. When PBOs fail to meet their legal obligations as PBOs, they are no longer entitled to that status and should be de-certified as PBOs.

It is important for the PBC and MOCA to maintain a website with a list of all certified PBOs. This information is necessary for the public to be informed about which organizations are properly certified as PBOs – and thus to know which organizations can receive tax deductible contributions. The website should be kept up to date on a weekly basis. In addition, the PBC should publish a hardcopy list of certified PBOs at least annually, for use by those without access to the Internet. Although other aspects of the recommendation to establish a PBC may take some time to implement, the development and publishing of the list should be accomplished as quickly as possible.

Conclusion

This Report contains a great deal of information – both academic and practical -- which supports the recommendations made. Decisions about whether to make or initiate any of these reforms could be made as part of the fundamental reform of the tax system that is currently underway in China. A number of the recommendations will take time to accomplish fully, but decisions could be made now to begin the reform process

A draft version of this Report was presented for discussion at two seminars held in late May in Beijing and Shenzhen. Many highly useful comments were made at those seminars by government officials, academics, and NPO practitioners, and the final Report reflects those comments. It was agreed by all who attended the seminars that significant revisions of the current tax system in China are needed to help the NPO sector to develop and mature so that it can better meet the needs of the Chinese people. There should, of course, be further debate and discussion of the recommendations made in the Report, but they present a useful starting point for discussion and decision-making with respect to the tax laws and policies affecting NPOs in China.

APPENDICES

These appendices provide summaries of the principal tax rules applicable to non-profit organizations (NPOs) in three leading countries: The United States, the Unite Kingdom, and Germany. These summaries are intended to give a sense of the entire system of tax laws that apply to NPOs so that their inter-relationships can be seen. Of necessity these summaries do not reflect all of the details of the NPO tax laws of any of the three countries, but they are useful in providing examples of tax regimes that can be found in many countries. As stated by Victor Thuronyi, the leading comparative tax expert of the International Monetary Fund, "a focus on these three countries (Germany, U.K., and the U.S.) will reveal most of the basic contrasts that would arise from including other countries in the study. In other words, diminishing returns apply by adding more countries to this basic group of three. The three countries are archetypes for the basic concepts of income . . . and have become leaders in influencing the tax laws of other countries in numerous respects." Comparative Tax Law p. 9 (Kluwer 2004).

Appendix A Provisions of the United States Federal Income Tax Laws Affecting Not-for-Profit Organizations

I. Introduction

The United States Internal Revenue Code of 1986, as amended (the "Code") contains the federal income tax laws of the United States. The various provisions of the Code are implemented in accordance with companion United States Treasury Regulations (the " Regulations"). The Code and the Regulations generally exempt from income tax many different types of organizations. They also allow individuals to deduct from their otherwise taxable income charitable contributions to certain of these exempt organizations. Through these tax exemption laws the government can encourage and indirectly subsidize certain types of organizations that serve public policy goals. The federal government's allowance of income tax deductions for charitable contributions also indirectly subsidizes a portion of those contributions, thereby encouraging the public to support those same goals. Because citizens rather than governmental bodies generally organize these organizations, federal tax policy provides a means by which the government can support civil society without direct intervention into it.

The types of organization that are generally exempt from federal income tax under the Code and Regulations range from the traditional philanthropic groups that advance religion, education, medicine, science and other charitable purposes, to many organizations less associated with traditional concepts of philanthropy. Some of these other types of exempt organizations include: civic leagues operated for the promotion of social welfare; labor organizations; agricultural or horticultural organizations; business leagues, chambers of commerce and boards of trade; non-profit clubs organized for pleasure and recreation; fraternal organizations operated under the lodge system; certain non-profit retirement funds, life insurance associations, cemetery companies and credit unions; and veterans groups.

The framework of the Code and Regulations determine which types of contributions are encouraged and which types of exempt organizations will receive preferred treatment with respect to such contributions. This is done by limiting the deduction that can be taken in a year depending on such factors as whether the contribution takes the form of money or property, what type and amount of property is contributed, and whether the donee is considered a "public charity" or a "private foundation."

The Code also aims to prevent tax-exempt organizations from carrying on a trade or business in a manner that unfairly competes with nonexempt commercial enterprises. This is accomplished by taxing certain income that is unrelated to the exempt purposes of such organizations.

The following is an overview of portions of the Code and Regulations relevant to tax exempt organizations and charitable contributions. Due to the complex nature of the Code and

Regulations, the overview must be limited to general summaries of the major sections relating to these subjects. It is not intended as a complete summary of this complex field of law.[122]

II. Tax Exempt Organizations

1. Section 501(c)(3)

The Code and Regulations describe a long list of specific organizations that are generally exempt from federal income tax.[123] Many of these exemption provisions benefit highly specific types of organizations, often under limited circumstances.[124] By contrast, section 501(c)(3), applies to a broad spectrum of "charitable" organizations and allows for a wide array of tax benefits. Section 501(c)(3) forms the centerpiece around which many of the most important laws involving exempt organizations and charitable contribution deductions revolve. Organizations described in section 501(c)(3) (often referred to as having "section 501(c)(3) status" or simply as "section 501(c)(3) organizations") are particularly important since they are the organizations that both (a) are generally federally tax exempt; and (b) are generally eligible to receive tax-deductible contributions.

Section 501(c)(3) status is accorded to:

> "corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . ., or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation . . ., and which does not participate in, or intervene in . . ., any political campaign on behalf of (or in opposition to) any candidate for public office."

1.1 "Organized and Operated Exclusively"

In order to be recognized as a tax exempt organization described in section 501(c)(3), the entity in question must be both organized and operated exclusively for one or more exempt purposes specified in the section.[125] The Code and Regulations impose both an organizational test and an operational test on organizations seeking recognition of tax exemption.

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[122] The general explanation provided by the Internal Revenue Service of the rules in this area can be found in IRS Publication 557: http://www.irs.gov/pub/irs-pdf/p557.pdf.

[123] For example, labor, agricultural, and horticultural organizations (§501(c)(5)), business leagues (§ 501(c)(6)), social and recreational clubs (§501(c)(7)), and mutual insurance companies (§501(c)(15)..

[124] For example, cemetery companies (§501(c)(13), black lung trusts (§501(c)(21), title holding corporations (§501(c)(25), and charitable risk pools (§501(n)).

[125] To receive a determination from the IRS that it qualifies as a section 501(c)(3) organization, an organization must file IRS Form 1023. This form and instructions for filing it can be found at: http://www.irs.gov/pub/irs-pdf/k1023.pdf.

The organizational test requires that an organization's articles of organization limit it to the pursuit of one or more "exempt purposes" and that they not expressly empower it to engage (other than insubstantially) in nonexempt activities. Therefore, for example, an organization cannot receive exempt status if its articles of organization empower it "solely to engage in a manufacturing business," regardless of the fact that they may also state "to raise funds for charitable purposes." The organization must also be organized so that upon dissolution, its assets will be distributed for exempt purposes or to one or more exempt organizations of certain specific types.

The operational test requires that a section 501(c)(3) organization engage primarily in activities that accomplish one or more exempt purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. The operational test will in many circumstances look to the organization's purposes as well as its activities. Thus, an organization may qualify as a charitable entity and still, within limits, conduct a business in furtherance of a tax exempt purpose.

Section 501(c)(3) requires that the organization must be organized and operated "exclusively" for exempt purposes. "Exclusively" in this context, however, is not interpreted to mean "solely" but rather "primarily" in the sense of "substantially." Thus, the presence of a nonexempt activity will not itself result in loss or denial of exemption where it is only incidental and less than substantial in relation to the organization's exempt purpose activities. In order to determine what the organization's purpose is in operating the nonexempt activity the Code and Regulations direct attention to such factors as profit motive, absence or presence of substantial profits, extent of competition with commercial organizations, reliance upon volunteers, amount of payment to salaried employees, and similar considerations.

1.2 Exempt Purposes

Section 501(c)(3) recognizes as exempt those organizations operated for religious, charitable, scientific, literary, or educational purposes, for testing for public safety, the fostering of national or international amateur sports, or the prevention of cruelty to children or animals. This is the general list of permissible "exempt purposes." The legal meaning of these categories has been developed in the Regulations and in rulings of various types interpreting the Code and the Regulations.

1.2.1 Charitable

The tax laws contain a general exemption for organizations dedicated to "charitable purposes." The Regulations provide that the term "charitable" is used in its generally accepted legal sense and is not to be construed narrowly or limited by the other e numerated purposes. It includes, but is not limited to: relief of the poor or underprivileged; advancement of religion; advancement of education or science; promotion of health (including hospitals); lessening the burdens of government; and promotion of social welfare by organizations designed to accomplish any of the above purposes.

There is no requirement that an organization must provide services only to low-income individuals to qualify as a charitable organization. There is also no general prohibition against charging fees for the services. The Code and Regulations look to the benefits flowing to the general public in assessing the presence of a sufficient charitable purpose. The Code and Regulations only require that the organization operate in the public rather than the private interest and that the persons benefited from the charitable activity constitute a sufficiently large or indefinite class. As a general proposition, a sufficient charitable purpose will not be found to be present if the beneficiaries of the alleged charitable works are specifically named or are relatives of the donors, or if the organization in question operates to benefit specifically ascertainable individuals, such as the members of a social club or fraternal organization.

1.2.2 Religious

The Code and Regulations also exempt organizations the purpose of which is to advance religion. The tax laws avoid describing or limiting the organizations that fall in this category. This is due to the U.S. constitutional doctrine separating church an d state and forbidding the government from supporting some faiths while rejecting others. An attempt in the Code and Regulations to define religious organizations more specifically could be viewed as precisely such a favoring or disfavoring of particular beliefs, and thus would be susceptible to legal challenges to the constitutionality of the definitions.

Although it is clear that this category of exempt organizations encompasses "churches," the task of deciding what constitutes a "church" is a difficult matter (given, among other factors, the constitutional issues mentioned previously) that must be decided on a case-by-case basis. In addition to churches, this category includes organizations that provide religious music, pay the clergy's salary, disseminate religious doctrine (including parochial schools), maintain missions, or distribute religious literature (including church newspapers).

1.2.3 Scientific

The advancement of science is also recognized as an exempt purpose. A "scientific" organization is one engaged in scientific research or otherwise operated for the dissemination of scientific knowledge. The organizations must serve a public rather than a private interest. Scientific research is not for a public purpose if it involves activities ordinarily carried on incident to commercial operations, for example, testing or inspection of materials or products). Research will be regarded as carried on in the public interest if: the results of the research are made available to the public; if it is performed for the government; or if the research is directed toward benefiting the public, such as aiding the scientific education of college students or discovering a cure for a disease.

1.2.4 Educational

Organizations promoting educational purposes are also considered exempt. The term "educational" relates to the instruction of individuals for the purpose of improving their capabilities or the instruction of the public on subjects useful to the individual and beneficial to the community. The instruction of individuals is an exempt purpose and exemption is not dependent upon the subjects under instruction or the motives of those being instructed. There is no general requirement that the general public be instructed. The training of individuals is seen as benefiting the public in that the individuals' increased capabilities serve to improve the public welfare. For example, a seminar conducted just for lawyers can ultimately benefit the public.

Organizations that are encompassed in this category include traditional schools, which have a regularly scheduled curriculum, a regular faculty, and a regularly enrolled student body as well as non-traditional groups that present public discussions, forum s, lectures or similar programs. Organizations that operate museums, zoos, symphony orchestras and similar organizations may also qualify. Organizations involved in publishing may qualify if the content is educational, the distribution is valuable in achieving the organization's exempt purpose, and the distribution manner is distinguishable from commercial publishing practices.

In addition to serving a public purpose, there is a general requirement that an organization's activities not be contrary to established public policy. The purpose must not be so at odds with the common community conscience as to undermine any public benefit that otherwise might be conferred. For example, a school that discriminates by race will be denied tax exempt status although it serves an educational purpose.

1.3 Private Inurement

Section 501(c)(3) requires that exempt organizations must be operated so that no part of their net earnings inure to the benefit of any private shareholder or individual. Inurement is likely to arise in the case of a transfer of the organization's direct or indirect financial resources to an individual by virtue of the individual's relationship with the organization and without regard to accomplishing the organization's exempt purposes. The private inurement doctrine embodies the critical feature distinguishing between for-profit and non-profit organizations under U.S. federal law: Organizations of the two different types may appear indistinguishable in many respects; but an organization that channels the benefits of its financial resources directly o r indirectly to those who control it will not be considered non-profit for purposes of federal law and will not qualify as an organization described in section 501(c)(3).

In order for impermissible private inurement to be found to exist, generally the private individual in question must be found to be an insider in the organization (frequently a corporate director, trustee or officer), and must generally be in a position to control or influence the organization's actions in connection with the benefit to be conferred. Unlike the requirement of a substantial exempt purpose (where insubstantial and incidental non-exempt purposes may be found to exist without preventing the organization from qualifying for section 501(c)(3) status), even the smallest amount of private inurement can potentially defeat an organization's claim to be a section 501(c)(3) organization. The prohibition against private inurement does not extend generally to non-pecuniary benefits that might inure to an insider. For example, when a park is named after its donor, the publicity and honor that inures to the donor will not in and of itself constitute private inurement.

Section 4958 of the Code was added to specify certain inurement transactions with respect to related parties and to make them subject to excise taxes if they do occur. The Code imposes on such transactions a 25% tax on the person benefited and a 10 % tax on the management of the organization that allowed the transaction to occur. Both amounts apply to the excess benefit (e.g., salary that is unreasonably high) paid to the related party.

1.4 Influencing Legislation

Section 501(c)(3) organizations are prohibited from dedicating a substantial part of their activities to carrying on propaganda or otherwise attempting to influence legislation--often referred as "legislative lobbying". It is generally irrelevant that t he legislation in question would advance the charitable or other exempt purpose that the organization was created to promote. Influencing legislation generally signifies any attempt to influence legislation through attempts to affect the opinions of the general public on legislation or through communications with members or employees of a legislative body or government officials. "Legislation " generally does not include actions by employees or officials of the executive branch or those of the independent regulatory agencies. In addition, organizations may: make available to legislative bodies the results of nonpartisan research; provide technical advice and assistance to a legislative body in response to a written request; appear before, or communicate to, the body with respect to decisions that might affect the existence of, power and duties, tax exempt status, or deductibility of contributions to the organization; and undertake certain communications with its members regarding legislation of direct interest to the organization. None of these activities will jeopardize an organization's section 501(c)(3) status.

The limitation on legislative lobbying is not an absolute prohibition, and many section 501(c)(3) organizations legitimately engage in advocacy activities that include legislative lobbying without such lobbying being considered "substantial" and thus jeopardizing their section 501(c)(3) status. Thus, if a large organization spends a small portion of its total expenditures on influencing legislation, it can still amount to a significant sum of money. In order to determine whether the organization's actions in this respect are substantial, the Code and Regulations permit an organization to elect to be governed by monetary guidelines limiting the amount that the group can expend on these types of activities under section 501(h). If an organization's expenditures surpass the applicable limits, the organization is subject to an excise tax on those expenditures above the limits. However, if an organization's expenditures surpass the applicable limit by 150 percent, the organization risks losing its tax exempt status.

Unlike public charities under section 501(c)(3), social welfare organizations under section 501(c)(4), which can have any of the purposes permitted for section 501(c)(3) organizations, are not prohibited from engaging in lobbying. Further, a section 501(c)(3) organization can control a section 501(c)(4) organization, which means that any lobbying activities that may not be carried out by the former can be carried out through a controlled section 501(c)(4) organization.[126]

It should be noted that not all section 501(c)(3) organizations are treated identically for purposes of the limitations on influencing legislation. As is discussed below, a subset of section 501(c)(3) organizations known as "private foundations" are generally prohibited from all legislative lobbying activities, although they may make available the results of nonpartisan analysis, study

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[126] See Regan v. Taxpayers With Representation, 461 U.S. 540, 5552-53(1983). Moreover, although a section 501(c)(4) organization, like a section 501(c)(3) public charity, may not engage in political campaigning, it can form a wholly controlled "political action committee," which would be free to engage in political campaigning. Branch Ministries, Inc. v. Rossotti, 211 F.3d 137, 154 (CADC 2000).

or research and are also permitted certain limited lobbying activity where their own existence, powers, duties, tax status or the tax status of the contributions they receive are at issue.

1.5 Political Campaigning

Section 501(c)(3) organizations are prohibited from participating or intervening in any political campaign on behalf of, or in opposition to, any candidate for public office. This type of activity is sometimes referred to as "electioneering." In contrast to the prohibition on dedicating a substantial part of a group's activities to influencing legislation, the prohibition on political campaigning is absolute. Section 4955 of the Code imposes an excise tax of 10 percent on an organization that makes any “political expenditure” to support or oppose candidates for public office. It should also be noted that many groups that enjoy tax exemption under a Code section other than section 501(c)(3) are specifically permitted to influence legislation or campaign politically, as discussed below.

1.6 Excess Benefit Transactions

Section 4958 imposes a 25 percent tax on any “excess benefit transaction” that involves a section 501(c)(3) organization and an influential insider (a “disqualified person”), such as a trustee, a director, a chief executive officer, or any individual who is+ in a position to exercise substantial influence over the organization. An excess benefit transaction is a transaction in which an economic benefit is provided to any disqualified person that exceeds the value provided to the organization by that person. An excess benefit transaction may include excessive compensation. If the transaction is not corrected by return of any excess amounts received, an additional 200 percent excise tax may be imposed. A ten percent excise tax may be imposed on any managers of the organization that participate in the excess benefit transaction.

1.7 Private Foundations and Public Charities

All section 501(c)(3) organizations must satisfy the organizational and operational tests described above, and are subject to the limitations described above with respect to influencing legislation and participating or intervening in political campaigns. A large subclass of section 501(c)(3) organizations, known as "private foundations," is subject to certain additional requirements regarding their activities and methods of operation. These additional requirements, sometimes referred to popularly as t he "private foundation rules," are enforced by a system of penalty excise taxes of potentially significant magnitude. Although the term does not appear anywhere in the Code or Regulations, section 501(c)(3) organizations that are not private foundations are generally popularly referred to as "public charities."

1.7.1 Qualification of Section 501(c)(3) Organizations as Public Charities

The Code and Regulations provide that all section 501(c)(3) organizations will be treated as private foundations, and will thus be subject to the private foundation rules, unless they qualify as one of the separately enumerated classes of organization known as public charities. Generally speaking, qualifying as a public charity will depend upon: the nature of the organization and its activities; the sources and proportion of its funding; or its relationship to one or more other public charities of a specific sort. The provisions governing qualification are complex, and the description of these provisions provided here is only of the most general nature.

The following organizations qualify as public charities simply because of the type of organization that they are and the type of activities they conduct: (1) churches and conventions and association of churches; (2) educational organizations; and (3) organizations providing hospital care, medical education, or medical research. In addition certain organizations affiliated with state-run educational organizations, certain governmental organizations that are organized and operated as section 501(c)(3) organizations, and certain organizations testing for public safety also qualify as public charities simply by virtue of their type and activities.

In addition to the above organizations that qualify as public charities based on type of organization and activities, the Code and Regulations describe two additional types of public charities the qualification for which depends upon the sources and proportion of funding they receive. These two types of public charity are called "publicly supported" organizations, because the funding requirements set forth in the Code and Regulations are aimed at assuring that only organizations with widespread financial support from the general public will qualify. One type of organization qualifies as publicly supported because it normally receives at least one-third of its basic financial support in the form of contributions and grants from the general public, from governmental entities, from certain other organizations that themselves qualify as publicly supported organizations, or from any combination of the foregoing. The other type of publicly supported organization provided for under the Code and Regulations must normally satisfy two tests: not more than one-third of its basic financial support may be investment income or certain income from commercial activities unrelated to the organization's charitable purposes; and at least one-third of its basic financial support must come in the form of a combination of contributions, membership dues, and income generated from the performance of the organization's charitable purposes.

The third type of public charity described in the Code and Regulations derives its public charity status by virtue of a special relationship with another public charity of a specific type. These organizations are referred to as "supporting organizations." The required special relationship will only exist where the supporting organization is organized and operated solely for the benefit of one or more specified qualifying public charities and only where the supporting organization is operated, supervise d or controlled by or in connection with the beneficiary organization or organizations.

1.7.2 Private Foundations and Operating Foundations

As mentioned above, all section 501(c)(3) organizations that do not qualify, or that cease to qualify, as public charities under one of the foregoing tests will be treated as private foundations. Within the general private foundation classification, a n umber of subcategories exist. For the most part, the differences among types of private foundations are important principally because of their effect upon the extent to which contributions to such organizations may be deducted from the otherwise taxable income of contributors. One sub-classification of private foundation worthy of separate discussion is what is known as an "operating foundation." Operating foundations are perhaps best understood in contrast to ordinary private foundations.

Broadly speaking, U.S. private foundations tend to possess three common attributes. First, their initial funding typically derives from a single source or a small number of sources, often the personal fortune of a single family or the resources of a particular business corporation. Second, they typically invest their assets so as to produce income with which to pursue their charitable purposes, rather than relying on substantial new contributions and other funding from the outside on an ongoing basis. Third, they frequently seek to accomplish their charitable purposes through grants and contributions to other charitable organizations (usually public charities), rather than by implementing a charitable program themselves directly.

Operating foundations typically differ from ordinary private foundations only with respect to this last attribute. Although the rules governing the various means of qualifying as an operating foundation are highly complex, their purpose generally is to distinguish foundations that use their financial resources directly for the active conduct of their charitable initiatives. An example might be a private foundation operating an art museum, which uses its investment income to purchase new works for its collection.

1.7.3 The Private Foundation Rules

As mentioned previously, private foundations are subject to a number of additional legal requirements that do not generally apply to public charities. The so-called private foundation rules reflect a recognition that private foundations are likely to have been formed by one or a small group of funders and therefore are inherently susceptible to manipulation to further private rather than public interests. Accordingly, the private foundation rules all aim in one manner or another to enhance the public accountability of private foundations and curb the potential for their misuse to confer personal benefits on persons and institutions closely associated with them. A comprehensive and potentially hard-hitting penalty excise tax scheme backs up the rules, providing incentives for compliance and correction when the rules are violated. Because the Code and Regulations limit qualification for public charity status to types of organizations likely to be held to greater public accountability, public charities are not subject to the private foundation rules unless they lose their public charity status.

The full complexity of the private foundation rules falls beyond the scope of this discussion. The brief description of the rules provided below summarizes some of their more important aspects, as well as some of the policy reasons for their existence.

a) Excise Tax on Investment Income

   As a means of generating revenues to offset the governmental costs of enforcing the private foundation rules, the Code and Regulations impose an annual excise tax of 2% of a private foundation's net investment income.

b) Prohibitions on Self-Dealing

   Perhaps the broadest and most significant of the private foundation rules are the prohibitions on what is referred to as "self-dealing." The self-dealing prohibitions apply to transactions directly or indirectly involving a private foundation and one or more natural or juridical persons who constitute "disqualified persons" with respect to the foundation in question under the Code and Regulations. The list of disqualified persons covers most people or organizations with a close connection to a private foundation, including: substantial contributors (such as a founder); officers, directors, trustees and people with similar responsibilities with respect to the foundation; persons with certain ownership interests in business enterprises which are substantial contributors to the foundation in question; family members of any of the foregoing; and certain corporations, partnerships, trusts and estates in which any of the foregoing own a substantial profit or beneficial interest.

Subject to the exceptions discussed below, the types of direct or indirect transactions between disqualified persons and a private foundation covered by the self-dealing prohibitions include the following: sales, exchanges and leases of property; lending of money or other extensions of credit; furnishing of goods, services, or facilities; payment of compensation; and transfers of income or assets of the private foundation in question to or for the use of a disqualified person. The Code and Regulations allow for some important exceptions to these very broad prohibitions. These exceptions permit, among other things, the following direct or indirect transactions between a private foundation and its disqualified persons: interest-free loans used in furtherance of the foundation's charitable purposes; goods, services or facilities furnished to the foundation without charge and used in furtherance of the foundation's charitable purposes; goods, services and facilities furnished to a disqualified person on a basis no more favorable than to members of the general public; and payments of compensation for personal services necessary to carrying out the foundation's charitable purpose, provided the compensation is not excessive.

It should be noted that there is considerable overlap between the types of transactions involving private foundations and disqualified persons that the self-dealing rules prohibit and the types of transactions between any section 501(c)(3) organization and its insiders that will constitute impermissible private inurement, as discussed above.

c) Minimum Distribution Requirement

Private foundations are generally subject to a requirement that they distribute a certain minimum amount annually in furtherance of their charitable purposes. "Qualifying distributions" may either take the form of grants to other organizations or direct expenditures by the foundation in question, although the grant approach is perhaps the more common. The amount that must be distributed is determined by a complex formula, but represents approximately 5% of the value of the foundation's investment asset s. Special rules apply to operating foundations, as discussed above.

d) Other Private Foundation Rules

Three other private foundation rules include a so-called "excess business holdings" limitation, a prohibition against jeopardizing investments, and a limitation upon so-called "taxable expenditures." The excess business holdings limitation applies generally to the permissible level of ownership by a private foundation and its disqualified persons in certain operating business enterprises that are not conducted as charitable activities. The jeopardizing investments rule operates as a general requirement that private foundations not invest their assets in risky ways that might jeopardize the carrying out of their charitable purposes. The prohibition against taxable expenditures encompasses a number of separate provisions, the most significant of which a re: the prohibitions against private foundations engaging in legislative lobbying or electioneering mentioned above; a prohibition against grants to individuals for travel, study or similar purposes unless certain pre-approved procedures are followed; a prohibition against grants to organizations unless they qualify as public charities or unless the foundation observes certain monitoring and reporting requirements; and a general requirement that all foundation expenditures be for one of the types of charitable purposes specified in the Code.

2. Other Exempt Organizations

In addition to the organizations exempt from federal income tax under section 501(c)(3), many others are also provided exempt status under other provisions of the Code. Generally speaking, contributions to these organizations are not deductible from the taxable income of the donor. In this respect, these organizations receive less favorable treatment under the Code and Regulations than section 501(c)(3) organizations.

2.1 Political Organizations

A political organization is a party, committee, association, fund, or other organization organized and operated primarily for the purpose of accepting contributions or making expenditures for an "exempt function" activity. "Exempt function" activities are those that are directly related to the influencing of the selection, nomination, or appointment of any individual to public office or office in a political organization.

A political organization is exempt from federal income tax to the extent that its income is received as contributions, membership dues, or proceeds from political fundraising and if such income is used for the organization's exempt function activities. Any gross income not derived from the above sources is taxable at the rate of tax applicable to for-profit corporations.

The amounts expended by political organizations for their exempt function activities are not considered income to the individuals on whose behalf such expenditures are made. However, where a political organization expends amounts for the personal use of any individual, the individual on whose behalf the amount is expended will be treated as having received taxable income.

The excess funds existing after a political campaign is over are treated as expended for the personal use of the person having control of the funds and taxed unless they are transferred to another qualified organization or held for a future exempt function.

2.2 Miscellaneous Exempt Organizations

Other groups the Code exempts from income tax include, among others: certain social welfare organizations including those that engage in substantial legislative lobbying and thus do not fit within the restrictions applicable to organizations described in section 501(c)(3); certain kinds of government-created organizations; labor (e.g., trade unions), agricultural or horticultural organizations (allowed to influence legislation and electioneer); business leagues, chambers of commerce and boards of trade (allowed to influence legislation and electioneer); non-profit social clubs; fraternal societies; cemetery companies; credit unions; veterans groups; and farmers cooperatives.

III. Unrelated Business Taxable Income

The Code taxes an otherwise tax-exempt organization's net income generated from certain business activities that are unrelated to the exempt purposes of the organization in question. The primary impetus behind the addition of the so-called "unrelated business income tax" to the Code and Regulations in the early 1950's was not to prohibit business activities by exempt organizations but to eliminate a perceived source of unfair competition with nonexempt commercial enterprises. Accordingly, the tax seeks generally to place the unrelated business activities of exempt organizations upon the same tax footing as those of the nonexempt commercial enterprises with which they compete.

The Code and Regulations impose tax with respect to an otherwise tax-exempt organization's "unrelated business taxable income." Speaking broadly, unrelated business taxable income is: an organization's gross income derived from one or more regularly carried on trade or business activities that are unrelated to the organization's exempt purpose, minus business expenses directly connected with the carrying on of the unrelated trade or business activities in question.

1. Unrelated Trade or Business

A trade or business is an activity that is carried on for the production of income from the sale of goods or the performance of services. Characteristics leading to the conclusion that an activity is a trade or business include the presence of a profit motive or the fact that the activity is carried on in a commercial or competitive manner. Neither characteristic is determinative.

The modification "unrelated" is added to the term "trade or business" to signify trade or business the conduct of which is not substantially related to the exercise or performance of the exempt purposes of the organization in question. To determine whet her a trade or business is "substantially related" to the purposes for which exemption was granted, the relationship between the business activities generating the income in question and the accomplishment of the organization's exempt purposes must be exa mined. A trade or business is related to exempt purposes only where the business activity has a causal relationship to the achievement of the exempt purposes in question. The causal relationship must be a substantial one that contributes importantly to the accomplishment of the exempt purposes. The fact that income is generated with which the organization can achieve its exempt purposes does not establish the required causal relationship. As might be predicted, determining with confidence, which trade or business activities will be held to be "substantially related" to an organization's exempt purposes and therefore shielded from taxation can be difficult. Among enumerable examples of uncertainty and administrative complexity caused by the need to determine whether commercial activities are substantially related to the achievement of exempt purposes is the case presented by a museum store selling a variety of merchandise. The question raised first is whether the sale of any of the merchandise in question is substantially causally related to the museum's exempt purposes, and, if so, which specific pieces of merchandise. There is also a category of “unrelated debt-financed income,” which is not further explored in this synopsis of the law.

2. "Regularly Carried On"

In order for an unrelated trade or business activity to be taxed, it must be regularly carried on by the organization. Specific activities will be deemed "regularly carried on" if they manifest frequency and continuity and are pursued in a manner similar to comparable commercial activities of nonexempt organizations.

Where commercial organizations normally conduct income producing activities year-round and an exempt organization performs such activity only a few weeks a year, such activity will generally not be deemed to be "regularly carried on." However, the performance of a business activity normally conducted year-round for one day each week constitutes the regular carrying on of a trade or business. For example, the operation of a sandwich shop at a fair for two weeks will not be considered as the regular conduct of a trade or business, however, the operation of a commercial parking lot for one day a week year-round would be. Certain income-producing activities occur so infrequently, that neither their recurrence nor the manner of their conduct will cause them to be regarded as a trade or business regularly carried on (e.g., a yearly fundraising dance).

3. Qualified Deductions

Although an exempt organization is taxed on the income generated from its regularly carried on unrelated trade or business activities, the organization may reduce the amount of income that is subject to tax by the amount of business expenses that are directly connected with the carrying on of the unrelated trade or business in question. Deductible expenses are generally the same as those allowed to for-profit businesses under the relevant sections of the Code and Regulations. In addition, the deduction s must be "directly connected with" the conduct of the unrelated business. The deduction must have a proximate and primary relationship to the carrying on of that business. Expenses, depreciation and similar items attributable solely to the conduct of t he unrelated business are proximately and primarily related to that business activity. Where expenses and other deductions relate to both exempt activities and unrelated business activities, the deductions must be allocated to the two uses on a reasonable basis.

4. Exceptions and Other Special Rules

The Code and Regulations describe a large number of general exceptions to treatment as an unrelated trade of business, of which three are of particular importance. The Code does not treat as an unrelated trade or business any activity where almost all o f the work is performed without compensation by volunteers; where the business is carried on by a tax exempt organization primarily for the convenience of its members, students, patients, employees, etc. (e.g., a cafeteria on the organization's premises); or where the business consists of selling merchandise, almost all of which has been contributed to the organization as a gift.

Another whole class of income that would otherwise fall within the definition of taxable unrelated trade or business income, but which is specifically exempted from such treatment by the Code and Regulations is passive investment income. Passive investment income that will be shielded from tax generally includes an exempt organization's income derived from interest, dividends, real estate rental payments, royalties, annuities, etc. Gains from the disposition of real estate are also excluded from unrelated business taxable income unless the property sold involves inventory held for sale in the ordinary course of business.

IV. Deductible Charitable Contributions

As previously indicated, the Code exempts from general federal income taxation a long list of specifically enumerated organizations. The fact that an organization is considered tax-exempt, however, does not necessarily signify that contributions to the organization may be deducted from the amount of the contributor's income that will be subject to taxation. Contributions are deductible only if made to certain tax-exempt organizations, generally those that serve a public benefit and are considered to be charitable, within the broad meaning of that term under U.S. law. In addition to limitations upon types of tax exempt organizations to which tax-deductible charitable contributions may be made, there are also complex limitations in the Code and Regulations with respect to the amount of such contributions that may be deducted from the otherwise taxable income of contributors in a given tax year. Generally speaking, individuals may not deduct in excess of 50% of their adjusted gross income with respect t o charitable contributions made during the tax year in question, and corporations may not deduct in excess of 10%. These limitations are subject to further special rules, as discussed below.

Charitable contributions that entitle the contributor to a tax deduction are narrowly defined in the Code and Regulations. Deductible charitable contributions are generally gifts made to or for the use of:

> those organizations exempt under section 501(c) (3) (except organizations testing for public safety); governmental entities (if used exclusively for public purposes); and (under certain circumstances) veterans organizations, fraternal societies or cemetery companies.

The last four categories of organization collectively account for a relatively minor proportion of purely charitable giving in the U.S. Accordingly, the provisions of the Code and Regulations applicable to section 501(c)(3) status are also among the provisions of greatest importance with respect to the tax-deductibility of charitable contributions. Charitable contribution deductions are available only for the wealthier taxpayers who “itemize” their deductions rather than taking the standard deduction.

The Code and Regulations include a large number of highly specific additional rules governing the tax-deductibility of charitable contributions to section 501(c)(3) organizations. These rules tend to be the subject of relatively frequent legislative change. Two general characteristics are reflected in the provisions governing tax-deductibility of contributions: the favoring of contributions to public charities over contributions to private foundations; and differing treatment for contributions of cash and property. The policies underlying the generally more favorable treatment of contributions to public charities include a preference for organizations with broader public support and presumably greater public accountability. The differing treatment of contributions of cash and of property flow from such concerns as the inherent difficulty (and abuse potential) of valuing property (especially in the case of certain types of property), and the necessity or advisability of factoring into consideration possible capital gains on any contributed property in calculating the contributors' allowable deduction.

V. Returns, Reports and Public Disclosure

The Code and Regulations require most exempt organizations to file annual returns with the federal government. These returns provide extensive and detailed information on the sources and applications of exempt organizations' funds. Different types of organizations are required to provide different types of information in their returns.[127] A public charity return, for example, requires (among other information) an itemization of gifts of more than $5,000 from any individual source; a disclosure of the compensation paid to officers and directors and a listing of the amount of all grants, gifts and contributions made by the organization. The return may require an organization to state such things as whether it has engaged in impermissible electioneering, received unrelated business income, or engaged in any self-dealing transactions or other transactions violating the private foundation rules. Additional reports may be required if one or more of such activities has been engaged in. Annual returns are generally open to public inspection, and failure to make returns available to the public as required by the Code and Regulations may result in penalties. Failure to file required reports and returns is subject to civil and criminal penalties.

Certain organizations are relieved of filing returns by section 6033 (small organizations, churches and other organizations determined by the government. The private foundation return rules, on the other hand, required voluminous reporting.

References

All references contained herein are to the United States Internal Revenue Code of 1986, as amended (the "Code"), which contains the federal income tax laws of the United States, and the United States Treasury Regulations (the " Regulations"), which implement the Code. For detailed information and analysis on the tax laws of the United States that affect not-for-profit organizations, see James J. Fishman and Stephen Schwarz, Taxation of Non-Profit Organizations (Foundation Press 2003).

[127] The basic annual report that must be filed by section 501(c)(3) public charities is IRS Form 990 or, for smaller organizations, Form 990 EZ. These forms can be found at: http://www.irs.gov/pub/irs-fill/f990.pdf and http://www.irs.gov/pub/irs-fill/f990ez.pdf. Instructions explaining these forms can be found at: http://www.irs.gov/pub/irs-pdf/i990-ez.pdf. Private foundations must file Form 990-PF: http://www.irs.gov/pub/irs-fill/f990pf.pdf.

Appendix B Tax Benefits of Public Benefit Civil Society Organizations in the United Kingdom

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Note: This report is based on information available at 31 March 2002. At the time of writing. the government had not yet announced its intentions in two important areas.. the PIU review of the regulation of the voluntary sector and the 2002 Budget proposals.

I. Brief Description of the Law Existing in the UK

1. Introduction: the Legal Framework

The United Kingdom comprises three legal jurisdictions: England and Wales, Scotland, and Northern Ireland. National tax laws apply throughout the UK. The local tax laws in each jurisdiction are substantially the same, but significant variations from the law in England and Wales are sometimes found in Scotland and Northern Ireland.

The main national taxes that are relevant to public benefit organisations (PBOs) are:

- taxes on income and capital gains, inheritance tax, social security contributions, and stamp duty (a tax on documents evidencing certain transfers of property), all of which are administered by the Inland Revenue;
- value added tax (VAT), customs duty, insurance premium tax, and climate change levy, all of which are administered by Customs & Excise.

The only local taxes are council tax and rates, which are taxes on the ownership or occupation of, respectively, residential and non-residential real property situated in the relevant jurisdiction. These taxes are administered by the local government authorities in each of the three jurisdictions.

In each of these jurisdictions, the manner in which PBOs are taxed depends largely on whether the PBO is an organization established for charitable purposes. If the PBO is not a charity, it will generally be taxed according to the same rules that apply to commercial organisations and by reference to its legal form. Gifts to non-charitable PBOs do not normally qualify for relief from tax, and in the case of larger gifts individual donors are potentially subject to inheritance tax on the gift.

If the PBO is a charity, the procedure for obtaining recognition as a charity for tax purposes will be determined by the jurisdiction in which it is established. In England and Wales, most charities must register with the Charity Commission. Registration by the Charity Commission is presumed to be conclusive evidence of its charitable status and is therefore binding on the Inland Revenue; accordingly, it is the practice of the Charity Commission to seek the views of the Inland Revenue in contentious cases before registering a charity. Since at present there is no equivalent registration requirement in Scotland or Northern Ireland, charities established in these two jurisdictions and charities established in England & Wales that are outside the jurisdiction of the Charity Commission must apply directly to the Inland Revenue for recognition as a charity for tax purposes.

The wording of the different statutory provisions by which taxation privileges are granted to charities varies but the legislation generally refers to bodies that are "established for charitable purposes only". In a majority decision of the House of Lords in 1891, *Inland Revenue v. Pemsel* (3 Tax Cases 53) concerning the meaning of this expression for income tax purposes, the court held that:

- charitable purposes must be interpreted in a broad sense to refer to the four categories of charitable purpose recognised by the general law (i.e. the relief of poverty, the advancement of education, the advancement of religion, and other charitable purposes beneficial to the community which do not fall into any of the preceding categories) rather than in the narrow sense of the relief of poverty;
- the interpretation of charitable purposes in a taxing statute must be applied evenly as between citizens of the different jurisdictions in the UK, and accordingly should be interpreted by reference to the law of charity in England & Wales rather than, for example, the law in Scotland (as was contended in the *Pemsel* case).

Although the *Pemsel* case was decided in the context of income tax, the decision has been applied in practice to other taxes in the UK, except where this conflicts with an express statutory provision limiting a tax privilege to a specific type of charity.

The courts have held, *inter alia,* that the following organisations, which might nevertheless be considered to be of public benefit, cannot be regarded as charitable:

- funds set up for the benefit of specifically named individuals;
- organisations that are not independent of ownership or control by the state;
- bodies which have political aims, including organisations that campaign for peace or changes in the law; and
- certain members' clubs, including amateur sports clubs, which mainly benefit their own members rather than the public at large.

Such non-charitable organisations are liable in principle to tax on all their income and capital gains, except to the extent that they can qualify for relief from tax on transactions with their own members as mutual benefit organisations (MBOs).

2. Overview of the Taxation of PBOS

The current framework for tax privileges for PBOs is summarised in the following table:

Tax	**Taxable event**	**Taxation of charities**	**Taxation on non non-charitable PBOs**
Income, capital gains or corporate tax			
	Capital gains	Exempt	Taxable
	Business sponsorship	Taxable unless an exempt sale of services	Taxable
	Donations	Not taxable	Not taxable
	Grants & subsidies	Not taxable unless funding an unrelated trading activity	Not taxable unless funding a trading activity
	Investment income	Exempt	Taxable
	Lotteries	Exempt	Taxable
	Membership fees	Not taxable unless part of an unrelated trade	Not taxable unless part of a non-mutual trade
	Sale of goods or services	Taxable unless: • promotes charitable purpose • small-scale fundraising event	Taxable except sales to members of MBO
	Payments to employees & board members	Taxable	Taxable
Social Security	Payments to employees & board members	Taxable	Taxable
Stamp duty	Acquisition of real estate & other property	Exempt	Taxable
Customs duty	Imports of goods from non-EU countries	Imports of most goods by charities for charitable purposes are exempt	Taxable
Insurance premium tax	Premiums for non-life insurance risks	Taxable	Taxable

Climate change levy	Supply of fuel & power for business use	Taxable unless used for non-business or certain domestic uses	Taxable unless used for certain domestic uses
VAT	Purchase of goods or services	Certain items are zero rated	Taxable
	Sale of taxable goods or services	Sale of goods donated to charity is zero rated	Taxable
	Purchase or construction of non-residential real estate	Zero rated if used by charity: • for non-business use • for local community recreation	Taxable
	Conversion or alteration of non-residential real estate	Zero rated if: • conversion to residential use • self-contained annexed to existing building in non-business use	Taxable
	Rental of non-residential real estate	Landlord has option to tax unless used by charity: • for non-business use • for local community recreation	Landlord has option to tax
Council tax	Occupation of residential real estate	Temporary exemption if empty for up to 6 months	Taxable
Business rates	Occupation of non-residential real estate	80% exemption + discretionary exemption of remaining 20%	Discretionary exemption up to 100%

The legislation applicable to the taxation, or relief from taxation, of the income and expenditure of charities is comprised mainly in the following statutes:

- Income and Corporation Taxes Act 1988 (ICTA);
- Taxation of Chargeable Gains Act 1992 (TCGA);

- Inheritance Tax Act 1984 (IHTA);
- Value Added Tax Act 1994 (VATA); and
- Annual Finance Acts (FA).

The discussion below focuses principally on income taxes and VAT, which are the main taxes that impact on the activities of charities in the UK.

The government completed a comprehensive review of the charity tax system in 1999. The key features of the new system were initially announced in the Pre-Budget Report presented to Parliament on 9 November 1999. Additional measures, which in some respects went further than the preliminary proposals, were included by the Chancellor of the Exchequer in his Budget proposals for 2000/01 announced on 21 March 2000. These measures were enacted in the Finance Act 2000 (FA 2000) and are described in more detail in the relevant sections of the paper below.

In July 2001 the government's Policy and Innovation Unit (PIU) announced a review of the legal framework governing the voluntary sector throughout the UK. Although the review was not established to cover taxation matters, it will examine the case for retaining the link between charitable status and the grant of tax privileges. At the time of writing, the results of this review are still awaited.

3. Taxation of Income and Capital Gains of Non-Charitable PBOS

The most common legal forms used by PBOs are the company limited by guarantee and the unincorporated association (both which are liable to corporation tax on their income and capital gains), and the trust (which is liable to income tax on its income and capital gains tax on its capital gains).

Unless specifically exempt, a PBO is liable to tax on its income and capital gains at the following rates for 2001/2002:

- companies and unincorporated associations are liable to corporation tax on their income and capital gains as follows (Section ICTA):

Taxable Profits (£)	**Tax Rate (%)**
Up to 10,000	10
10,001 – 50,000	22.5
50,001 – 300,000	20
300,001 – 1,500,000	32.5
Over 1,500,000	30

- trusts are liable to income tax on their income and to capital gains tax on their capital gains as follows (Sec. 686 ICTA 1988):

Income	Tax Rate
Income arising during the administration of the trust	Basic rate of income tax (currently 22%)
Income to be accumulated or payable at the discretion of the trustees or any other person	Special rate applicable to trusts (currently 34%)
Dividend income	Schedule F trust rate (currently 25%)
Capital gains	Special rate applicable to trusts (currently 34%)

The main statutory exemptions applicable to non-charitable PBOs include:

- profits from exhibitions or shows of agricultural societies (Sec. 510 ICTA); and
- income of scientific research organizations (Sec. 508 ICTA).

In addition, income from small-scale fund-raising events organized by a non-charitable PBO raise funds for a charity is exempt by extra-statutory concession (ESC C4).

It should also be noted that some mutual benefit organisations (MBOs) may be considered to of public benefit, e.g. where all the members are relatively poor or otherwise disadvantaged, although they will not necessarily be charitable under UK law. Such MBOs can benefit from exemption from taxation on income from mutual trading transactions with members entitled to participate in a common fund of the MEO to which they have contributed.

4. Taxation of Income and Capital Gains of Charities

Exemption from tax on most of the various forms of income that charities derive is granted in Sec. 505 ICTA to any body of persons or trust "established for charitable purposes only". The exemption generally applies to both UK source and foreign source income, but the courts have decided that the tax exemption does not extend to non-UK charities, the leading cases being *Inland Revenue v. Gull* (21 Tax Cases 374) and *Dreyfus Foundation v. Inland Revenu*e (36 Tax Cases 126).

Non-trading income is generally exempt from taxation under Sec. 505(1) and (2) ICTA. This exemption covers real property income, dividends, interest, royalties, annuities and tax deductible gifts received from donors. In most cases such income is not subject to any UK withholding tax, and where tax has been withheld by the payer it can be reclaimed by the charity.

A charity was able to claim repayment of the 20/80 tax credit attaching to a dividend received from a UK company prior to 5 April 1999. From 6 April 1999, as a result of the abolition of Advance Corporation Tax, the dividend tax credit was reduced to one ninth of the gross dividend and is no longer repayable. As a temporary compensation measure, a transitional relief was granted to charities, whereby an amount based on the notional dividend tax credits arising in the period 6 April 1999 to 5 April 2004 can be reclaimed by the charity (Sec. 35 Finance (No.2) Act 1997).

Capital gains on assets owned by a charity are exempt from taxation under Sec. 256(1) TCGA.

The tax exemptions noted above are conditional on the income or capital gains being applied for charitable purposes only. In addition. if the total amount of these exemptions in any accounting period is £10,000 or more and exceeds the amount spent on charitable purposes, the exemptions can be restricted to the extent that the charity incurs "non-qualifying expenditure" (section 505 (3) ICTA). Non-qualifying expenditure is broadly defined in section 506 ICTA to include:

- expenditure on non-charitable activities;
- investments and loans that are not specifically authorised by the law or the Inland Revenue; and
- payments to an overseas body unless the charity has taken reasonable steps to ensure that the money will be applied to charitable purposes.

Investments in unlisted companies (including investments in an affiliated body) generally require specific clearance by the Inland Revenue (Schedule 20 ICTA).

<u>Charity Trading Activities</u>

Charities are also exempt from tax on the profits (income and capital gains) of a trade:

- carried on in furtherance of the primary purpose of the charity (Sec. 505(1)(e)(i) ICTA);
- where the work is mainly carried on by the charity's beneficiaries (Sec. 505(I)(e)(ii) ICTA);
- in the form of a small or society lottery (Sec. 505 (l)(f) ICTA).

All these reliefs are subject to the conditions noted above. The primary purpose exemption is limited to activities that implement or promote the aims of the charity (e.g. education provided by a school), and excludes fundraising activities.

A new statutory relief for small-scale trading by charities was introduced by Section 46 FA 2000. This relief supplements the existing exemptions from tax on the profits of charity trading. This exemption applies to the profits of all trading and certain other incidental activities of charities that are not otherwise exempt from tax, provided that:

- the total turnover from all such activities does not exceed an annual limit (unless the charity had a reasonable expectation that the limit would not be exceeded) ; and
- the profits are used solely for the purposes of the charity.

The annual turnover limit is the greater of £ 5,000 and 25% of the charity's "incoming resources", subject to all overall turnover limit off 50,000. The exemption covers not only trading profits but also incidental income taxable under Schedule D Case VI, unless specifically excluded by the legislation. The exclusions are intended to prevent the exemption of income that is normally taxed under Case VI by means of an anti-avoidance provision.

The ability of a charity to benefit from this new relief depends on its legal capacity as set out in its governing instruments. If the wording corresponds to that of the Charity Commission's model governing documents (which prohibits "any substantial permanent trading activity") the charity will generally be able to carry on any of the activities within the scope of the new exemption in its own name without having to set up a separate trading company to do so.

For many years the profits of small-scale fundraising events organised by or for the benefit of charity have been exempt by extra-statutory concession (ESC C4). With effect from 1 April 2000 the scope of the exemption was broadened to align the definition of qualifying events with that used for VAT purposes (Inland Revenue Press Release, 3 April 2000). At the same time the scope of the VAT relief was also broadened with effect from 1 April 2000 (VAT (Fundraising by charities and other qualifying bodies) Order 2000). The definition of fundraising events that qualify for exemption includes up to 15 events each year of anyone kind and in any location, including Internet-accessible events. Small-scale events (e.g. coffee mornings and jumble sales) are not subject to this restriction, provided that the total gross receipts from such events do not exceed £ 1,000 in one week. If the takings exceed £ 1,000, the event counts towards the 15 event limit. Once the 15 event limit is exceeded, every event in the programme of events of the same kind is taxable. Events organized jointly by one or more charities and qualifying bodies can qualify for exemption, but only if all the bodies involved have organized less than 15 exempt events of that type in that location in their financial year.

The profits (income and capital gains) of a trade carried on outside the scope of the reliefs noted above are liable to tax without any special reliefs. For convenience, such trades are referred to in this paper as "unrelated business activities", although this term has no legal significance in the UK and the precise scope of the tax base differs from that applied, for example, in the USA.

However, it is possible for a charity to avoid liability to tax on profits from unrelated business activities by carrying out the trade through a company owned by the charity. In principle, the trading company is liable to corporation tax on its profits under the same rules that apply to commercial companies, but the taxable profits can be reduced to nil by donating them to the parent charity by way of payments under the Gift Aid rules (see below). In practice, most charity trading companies currently donate their profits to their parent charities in this way and it is accepted by the Inland Revenue. This would not be possible in most other countries because they generally impose a maximum limit (either a fixed amount or a percentage of income) on the deduction from taxable income of donations to PBOs.

5. Value Added Tax (VAT)

UK law relating to VAT generally accords with the provisions of the EC 6th VAT Directive. This paper therefore focuses on the VAT provisions in UK law relevant to PBOs that represent a derogation from the requirements of the 6th Directive or involve an exercise of discretion by Customs & Excise in their interpretation or application of the law.

These provisions generally relate to one of the following issues: -the definition of a taxable person; the scope of the tax base;

- the conditions imposed on the grant of exemption for certain supplies by PBOs; -the use of tax rates reduced below the standard tax rate (currently 17.5%); and

- the methods of calculating recoverable VAT available to PBOs that are partially engaged in non-business or exempt business activities.

The 6th VAT directive defines a taxable person as a person engaged in an economic activity. This concept is expressed in UK domestic law as the carrying on of a business. There is no definition of business for this purpose; in practice, the same tests are generally applied to both PBOs and other taxpayers to determine whether they are carrying on a business. Examples of common activities of charities that are treated as non-business activities include: the receipt of donations and grants provided that no benefits are provided in return; campaigning activities; the provision of free literature to members; and free admission to premises for non-members. Where, however, services are provided by a charity under a funding agreement with a public body that takes the form of a commercial contract rather than a grant of public funds the activity will be regarded as a business activity; this has occurred more frequently in the UK in recent years as a result of local authorities replacing grant funding agreements with contracts. Where an activity is funded partly by charges and partly by government grants, it will be regarded as a business activity, although the grants will generally be outside the scope of VAT.

Special rules apply in the following cases:

- the supply of welfare services and related goods by charities is by concession treated as a non-business activity when supplied to people in need free of charge or for a consideration that is consistently below cost. For this purpose a supply will be regarded as below cost if at least 15% of the cost of providing the welfare is financed out of the charity's own funds;

- a charity's transactions in investments, no matter how substantial, are generally regarded

- a non-business activity (this follows from the decision of the European Court of Justice in Wellcome Trust Ltd. v. Commissioners of Customs & Excise, Case C-155/94, [1996] ECR 1-3013);

- although the distribution of goods free of charge by a charity is a non-business activity, the export of such goods (e.g. for the purposes of disaster relief) is deemed to be a business activity (section 30 (5) VATA) in order to enable the charity to reclaim the VAT paid on the purchase of the goods and related costs;

- the receipt of membership subscriptions by a charity or another nonprofit organisation is not treated as a business activity unless significant facilities or benefits are supplied to members in return, and the right to participate in the management of the organisation or to receive reports of its activities are not regarded as significant for this purpose (section 94 (3) VATA);

- nonprofit environmental projects funded wholly by landfill tax credits for contributions by landfill site operators (and from which the contributor is precluded by the tax law from receiving any direct benefit) are regarded as non-business activities.

Article 4.5 of the 6th Directive provides that central and local government authorities and "other bodies governed by public law" are not considered to be taxable persons in respect of activities undertaken in the capacity of a public authority, except where this would lead to significant distortion of competition, and that for this purpose Member States can consider activities exempt- ed under articles 13 or 28 as activities undertaken as public authorities. Since the UK does not have a separate system of law for private and public bodies, it is not clear which bodies can be considered to be governed by public law. The limited judicial guidance on the subject to date suggests that only those charities that are performing a public function and are paid out of public funds can fall into this category.

The tax base in UK domestic tax law corresponds closely to that laid down in the 6th Directive in that the UK generally seeks to comply with the requirement to exempt certain activities in the public interest, as set out in Article 13A. However, the UK has not implemented the exemption of the supply by independent groups to their members of services that are directly necessary for the exercise of their activities (Article 13 At (t) or the exemption of supplies to members by nonprofit organisations of a "civic nature" (part of Article 13 Al (1», in both cases on the grounds that the meaning of the language in the Directive is not clear and that it is likely that sup- plies by a body within the scope of either of these exemptions would also qualify for exemption under another heading.

Article 13A of the 6th Directive allows Member States to define the conditions on which they will grant exemptions in the public interest. Perhaps the exemption with the widest application to PBOs is that of fundraising events, in relation to which the conditions that apply in the UK are described in the section on charity trading activities (see above).

Of all the Member States, the UK has perhaps made the most extensive use of reduced tax rates, and in particular the use of a zero tax rate for certain taxable supplies, which enables the supplier to avoid having to charge VAT to the customer while retaining the right to recover input tax on purchases attributable to that supply. Zero rating (sometimes called "exemption with credit") is a valuable relief to most charities because it is available for certain supplies:

- to charities (e.g. construction costs of a building to be used for certain residential or non-business purposes, equipment designed for use by people with disabilities, certain medical and scientific equipment, and some types of advertising and printing costs); and
- by charities (e.g. 'sale of goods donated to a charity, equipment designed for use by people with disabilities, books and other publications, distribution of goods overseas free of charge).

In addition to the zero rate, the UK has only one other reduced rate of 5%, which applies to sup- plies of fuel and power to charities for non-business use. The UK has not made use of the temporary scheme for the application of a reduced rate to supplies of certain labour-intensive services from 2000 to 2002 authorised by EC Council Directive 1999/85/EC of 22 October 1999 (OJ L277, 28 October 1999).

Charities that carry on a range of activities that are either partly non-business or, if wholly business, are partly exempt must perform two separate calculations to compute the amount of VAT that they can recover on their purchases: first, an allocation of total input tax between non-business and business activities; second, an allocation of business input tax between exempt and tax- able supplies. For both purposes Customs & Excise generally uses a calculation based on the value of the supplies in each category to apportion the input tax; this is called the "standard method". However, charities can apply for permission to use a "special method" where this to their advantage and will not distort their input tax recovery rate. Customs & Excise will accept special methods based on input tax values, numbers of staff employed in different activities, floor areas used in different activities, and other methods that produce a fair and reasonable result. It is not necessary to use the same method for both calculations, but the method selected must be used consistently, and Customs & Excise can direct the charity to adopt the standard method if an approved special method subsequently produces unreasonable results.

Member States are permitted to allow bodies under common ownership to be registered as a group for VAT purposes, which enable supplies between members of the group to be disregarded for VAT purposes and consequently can affect the calculation of input tax recovery by charities that are partly non-business or exempt. The UK has introduced group registration, and this is sometimes used by charities and their trading subsidiaries. However, group registration is not always beneficial and in some cases, depending on the nature of the supplies involved, it may be preferable for a charity and its trading subsidiary to have separate registrations.

Another important area where the determination of the availability of relief from VAT is left to each Member State concerns the application of the specific exemption in EC law for certain goods imported by approved charitable or philanthropic organisations (Council Directive 83/181/EEC of 28 March 1983, Articles 40 to 55). Whereas it appears that in some other Member States the benefit of this relief is granted only to approved PBOs engaged in a narrow range of activities such as the relief of poverty and distress, in the UK Customs & Excise generally interpret this relief as being available to all PBOs that have charitable status.

6. Taxation of Gifts to PBOS

The main taxes applicable to gifts to PBOs are income or corporation tax and inheritance tax. VAT is also relevant to gifts by business donors.

Gifts of assets to charities are exempt from capital gains tax (Sec. 257 TCGA).

Gift and Inheritance Taxes

The only general tax on gifts in the UK is inheritance tax which is imposed on gifts made either during their lifetime or on death by individuals domiciled in the UK. The tax is generally payable by the donor, rather than the recipient, and is assessed on the value of the estate on death or the cumulative value of lifetime gifts made less than 7 years before death. The tax is charged at a flat rate of 40% on cumulative lifetime gifts or estates over an exempt threshold (currently £ 242,000).

Gifts to charities are generally exempt from inheritance tax, provided that the donor does not retain an interest in or benefit from the asset concerned (Sec. 23 IHTA).

With limited exceptions, gifts to non-charitable PBOs are generally liable to inheritance tax. There is a scheme for exempting national heritage assets from inheritance tax, to which the Finance Act 1998 made minor changes. The prior exemption for gifts of national heritage assets to certain non-charitable PBOs was withdrawn for lack of use, and the conditions under which tax relief is granted to private owners of heritage assets that are open to the public were tightened by withdrawing the facility for owners to opt for public access to the assets only by prior appointment (Secs. 142 to 145 FA 1998).

Income Tax

For income or corporation tax purposes, gifts received by both charitable and non-charitable PBOs are generally not considered to form part of their taxable income, provided that no benefits are provided by the PBO to the donor in return for the gift. However, the donor can only obtain tax relief for the gift if it is made to a charity and subject to the rules described below.

Prior to the March 2000 Budget, gifts of money to charities were allowable deductions from taxable income for income or corporation tax purposes if they took one of the following forms:

- a single donation of at least £ 250 under the "Gift Aid" scheme (Sec. 25 FA 1990); -a series of payments under a deed of covenant lasting at least 3 years (Sec. 339 ICTA for companies and Sec. 347A(2)(b) ICTA for individuals);
- gifts of up to £ 1,200 a year by an employee under a payroll giving scheme established by the employer (Sec. 202 ICTA).

The Finance Act 2000 made major changes to these rules, including in particular the removal of the monetary limits on Gift Aid and payroll giving, and the abolition of the rules relating to deeds of covenant and their replacement by the new Gift Aid rules. In addition, a new income tax relief for charitable gifts of shares and securities was introduced.

The new Gift Aid rules apply to:

- covenanted payments by individuals that fall due after 5 April 2000;
- all other donations by individuals made after 5 April 2000; and
- all donations by companies, including covenanted payments, made after 31 March 2000.

The mechanics of the tax relief for gifts of money vary between individual and corporate donors, and generally work as follows. If the donor is a company, it pays over the whole amount to the charity and deducts the gross amount of the gift from taxable profits. If the donor is an individual, the gift is paid less basic rate income tax, which the donor retains and the charity reclaims from the Inland Revenue. For example, a payment to a charity by an individual of £ 780 is treated as a donation of £ 1,000 from which the donor has deducted income tax, currently at the basic rate of 22%. The individual donor retains the £ 220. If he is a basic rate taxpayer, there is no further relief to be claimed. If he is a higher rate (40%) taxpayer, the gross payment (£ 1,000) is deducted from his income chargeable at 40%, and the total amount of his relief should be £ 400. He has deducted (and retained) £220; he can also claim to reduce his tax liability by an extra £ 180.

There are important differences between the rules regarding individual donations and those for corporate donations. In particular:

- companies do not have to deduct basic rate income tax from their donations;
- consequently, charities cannot reclaim any tax on corporate donations; and
- company donors do not have to supply a Gift Aid declaration.

Another change, that was apparently intended to encourage low-income donors, replaced the previous requirement that individual donors have sufficient income liable to tax at the basic rate to cover the amount of their donations, with a new condition that the donor must have an income or capital gains tax liability that is equal to or greater than the tax that the charity can reclaim on the donation. While this change goes some way to providing tax relief for donors who pay tax at the 10% rate, there is still no relief for non-taxpaying donors. However, the Inland Revenue has indicated that in cases where charities have reclaimed tax on donations by non-taxpayers, they will ask the charity to repay the tax before seeking to collect it from the donor.

Under the FA 2000 rules all individual donors must provide a Gift Aid declaration. Before a charity can reclaim tax;(on a donation by an individual, it must hold a declaration by that individual. The requirements for such declarations are specified by regulations (The Donations to Charity by Individuals (Appropriate Declarations) Regulations 2000 Regulations issued on 28 July 2000). Guidance on the information and records required for a declaration to be valid is also given in the Inland Revenue guidance note Getting Britain Giving issued on 21 March 2000.

The guidance note explains how the new rules are intended to make giving simpler and more flexible. Individuals can now provide a declaration:

- before, at the time of or, subject to the time limit for reclaiming tax (i.e. normally 6 years), after the donation;
- which covers a single donation or any number of donations; or
- orally (e.g. by telephone) or in writing (e.g. by post, fax or Internet)

Declarations can cover future donations for an indefinite period without needing to be renewed periodically. However, if donors' circumstances change such that they have insufficient income or capital gains to cover their donations, they will incur an additional tax liability.

The declaration does not have to be signed by the donor, but all declarations must include the following details:

- the donor's name and address;
- the charity's name;
- a description of donation(s) covered by the declaration; and
- a declaration that the donations are intended to be Gift Aid donations.

In addition, written (but not oral) declarations must also include:

- an explanation of the requirement that the donor must pay an amount of income tax or capital gains tax equal to the tax deducted from the donation; and
- the date of the declaration.

The details identifying the donor and the charity need to be sufficiently precise to enable each party to be identified and traced in the event of an audit of the charity's tax reclaims. A model declaration form, which includes some details over and above the minimum requirements, has been issued as an Appendix to the Inland Revenue guidance note. Charities can design their own declaration forms; these do not need Inland Revenue approval but the Financial Intermediaries and Claims Office (FICO) will issue approvals on request.

If a charity receives an oral declaration it must send the donor a written record of the declaration, otherwise the declaration will not be effective. This record must include:

- all the details provided in the oral declaration;

- an explanation of the requirement that the donor must pay an amount of income tax or capital gains tax equal to the tax deducted from the donation;
- the date of the declaration;
- a note explaining the donor's entitlement to cancel the declaration retrospectively (see below); and
- the date when the record is sent to the donor.

The charity cannot reclaim tax on any donations covered by an oral declaration until it has sent the written record to the donor. Once this has been done, tax can be reclaimed on all such donations, whether received before or after the written record was issued.

Individual donors can cancel their declarations at any time, orally or in writing. Charities should keep a record of all cancellations, including the date of cancellation. Cancellation affects only donations received by the charity on or after:

- the date when the donor notifies the charity of the cancellation; or
- such later date as the donor may specify.

Cancellations can have retroactive effect, but only if they are notified to the charity within 30 days after the charity has sent the written record to the donor. Charities can still reclaim tax on the donations received before the end of the 30-day period but, in the event of cancellation within the period, they will have to repay the tax to the Revenue.

The new regime does not alter significantly the form of records that charities must retain to substantiate their tax reclaims. The main requirement is to keep sufficient records to show an audit trail .linking each donation to an identifiable donor who has given the charity a valid declaration. Charities need to retain indefinitely records of declarations covering future donations without a time limit.

<u>Benefits Received by Donors</u>

The limits on the benefits that donors can receive under the FA 2000 rules represent a synthesis of the different rules previously applicable to Gift Aid donations and covenants. If the value of the benefit exceeds these limits, the donation cannot qualify as a Gift Aid donation.

Benefits that are disregarded for this purpose comprise:

- an acknowledgement of the donor in the charity's literature or on a plaque, provided that this does not take the form of an advertisement for the donor's business;
- free or reduced price admission for the donor and his or her family to property of heritage and conservation charities solely for the purpose of viewing the property or wildlife and on terms that are generally available to any member of the public making a similar donation; and
- charity literature that is not normally sold to the public and is produced for the purpose of describing the work of the charity (e.g. newsletters, members' handbooks, etc.).

The guidance note indicates that the Revenue will accept that the second relief is available where charities have rules that restrict the right of admission to family groups (e.g. to a maximum of two adults and six children).

Other benefits must satisfy a twofold test. A donation will not qualify *for* Gift Aid relief if:

- the value of the benefits relating to the donation, plus the value of any benefits relating to prior Gift Aid donations by the same donor to the same charity in the same tax year, exceed £ 250 (the "aggregate value test"); and
- the value of the benefits relating to each donation exceeds the following limits (the "relevant value test"):

Donation in £	**Value of benefits**
0-100	25% of the donation
101-1,000	£ 25
over 1,000	2.5% of the donation

In addition, special rules apply to annualize the amount of certain donations and the value of the relevant benefits in order to apply the same limits to situations where donors receive benefits for a period of less than 12 months.

In the case of charity auctions, the guidance note indicates that the Revenue is prepared to accept that the intrinsic value of a benefit may be significantly less than the price paid. If the donor can show that the market value is significantly less than its sale price, the lower value can be used for the purposes of the benefit tests.

Where the value of the benefits exceeds the limits, the donor can specify that part of the payment is to be treated as made in return for the benefits and part is to be treated as a donation. Provided that the donor specifies this split treatment before or when making the donation, the part specified to be a donation can qualify for Gift Aid relief.

Deeds of Covenant

It is still possible to make donations to charity under deeds of covenant but the availability of tax relief is determined solely by the rules of the Gift Aid regime (Sec. 41 FA 2000). This applies to payments under pre-existing covenants if:

- they are made by companies after 31 March 2000; or
- they fall due for payment by individuals after 5 April 2000 (Sec. 41 FA 2000).

Gift Aid declarations are required for covenants executed by individuals after 5 April 2000 but not for payments under prior deeds.

Payroll Giving

Payroll giving was introduced in 1986 as a means of encouraging employees to make charitable donations via schemes established by their employer. Gifts under a payroll giving scheme can be made without deduction of tax. Under a payroll giving scheme the donations are deducted by the employer from the employee's pay and distributed to the charities selected by the employee via payroll giving agencies approved by the Inland Revenue. Tax relief for the donations is granted by reducing the income tax deducted from the employee's pay by the appropriate amount.

From 6 April 2000 there is no limit to the amount that employees can give under a payroll giving scheme (Sec. 38 FA 2000). Moreover, the government will pay a 10% supplement on all donations made under a payroll giving scheme in the period from 6 April 2000 to 5 April 2003. The supplement is distributed to charities, free of any administration fees, via the payroll giving agencies together with the relevant donations. Under a separate measure which took effect from 6 April 2000, payroll giving agencies must now distribute payroll donations to the charities selected by donors within 60 days of their receipt (The Charitable Deductions (Approved Schemes) Regulations 2000, issued on 16 March 2000).

Business Donors

Other income and corporation tax reliefs that can be claimed by an individual or a company as expenses of a business include:

- relief for the cost of remunerating an employee temporarily seconded to work for a charity (Sec. 86 ICTA);
- gifts of equipment to educational establishments (Sec. 84 ICTA); and
- by concession, the cost of small gifts to local educational, cultural, religious, recreational or benevolent PBOs (ESC B7).

A further method by which an individual or company carrying on a trade can support a charity is a sponsorship payment. Sponsorship payments, whether or not for a charitable activity, are deductible expenses, provided that the payment is made wholly and exclusively for purposes of the payer's trade and is not of a capital nature (section 74 ICTA) on the basis that a payment made to obtain publicity for the payer's name or product, which represents a reasonable commercial price to pay for the publicity, is an allowable expense of the trade. If a proposed payment is in excess of the commercial rate for the publicity, the excess can be paid in the form of a charitable donation. However, business sponsorship payments may give rise to taxable income in the hands of the recipient charity depending on the nature of the sponsorship.

Gifts of Shares and Securities

The new relief for gifts of certain shares and securities to charity is completely separate from the Gift Aid regime (Sec. 43 FA 2000). It applies, in addition to the existing exemption from tax on capital gains, to disposals to a charity by individuals or companies of the whole of the beneficial interest in any qualifying share or security by way of gift or a sale at undervalue.

The relief takes the form of a deduction of:

- the market value of the gift;

- plus any incidental cost of disposal (e.g. brokers' fees); and
- less any consideration or other benefit received as a result of the gift.

Corporate donors can claim the relief as a deduction from their total profits for the period in which the disposal occurs. For individual donors, the relief is only available as a deduction from their income (not capital gains) for the tax year in which the gift is made. As no tax is deducted from the gifts, charities cannot reclaim tax on such donations.

The new relief is limited to disposals of the following categories of shares and securities:

- shares and securities that are listed or traded on a recognized stock exchange in the United Kingdom or abroad;
- units in an authorized unit trust (a type of collective investment scheme); -shares in a UK open-ended investment company; and
- holdings in offshore funds (i.e. certain foreign collective investment schemes, as defined by Sec. 759 ICTA).

The reference to shares that are traded on a recognized stock exchange enables relief to be claimed for gifts of certain categories of unlisted shares, e.g. shares traded on the Alternative Investment Market (AIM). The guidance note indicates that the Inland Revenue will be prepared to advise whether a particular share or security qualifies for the relief.

Loans to Charity

There is anti-avoidance provisions in the legislation relating to trusts and settlements legislation (Part XV ICTA) which is capable of taxing income foregone by individuals by means of interest free or subsidized loans to others, including charities. In many cases the Inland Revenue has not in practice sought to apply these provisions to charitable loans, but it has generally been advisable to seek clearance for such transactions. The law has now been amended to take interest free or subsidized loans by an individual to a charity outside the scope of these provisions (Sec. 45 FA 2000). However, the lender is not able to claim any tax relief for the amount of interest foregone on the loan.

II Description of Main Problems of Regulation

1. VAT

The main concern of the UK charity sector in recent years has been the burden of irrecoverable VAT paid by charities engaged wholly or partly in non-business or exempt business activities. A recent study estimated that the total annual cost of irrecoverable VAT to the charity sector was £ 350 million, and that the costs related primarily to the supply of services that were a priority for the allocation of central government expenditure (e.g. education, health and welfare services). Although this issue derives from the VAT system imposed by the EC 6th VAT Directive and should therefore in theory apply to PBOs in all of the EU Member States, in practice UK charities have been more involved in campaigning to improve the EC VAT regime than PBOs in other Member States. It is not clear why this is so, although it has been suggested that central and local governments in other Member States may be more willing to fund the expenditure of PBOs including the costs of irrecoverable VAT.

In 1999 the government rejected the charity sector's proposal for a rebate scheme to cover the cost of irrecoverable VAT on non-business activities, mainly on the grounds of cost. Since 1999, however, the government has extended the scheme for local authorities to reclaim VAT on public activities by allowing national museums and galleries a similar relief (section 33A VATA), although it maintains that this does not set a precedent for the introduction of a wider rebate scheme.

Other areas of VAT which cause concern derive from the EU's programme for the development of the EC VAT system, in particular the European Commission's proposals to abolish exemptions and reduced rates. The UK charity sector has therefore been seeking:

- the replacement of exemptions under Article 13 of the 6th Directive for certain supplies in the public interest with taxation at reduced rates;
- the preservation of the existing zero and other reduced rates enjoyed by PBOs; and -the introduction of an option for PBOs to charge VAT on exempt supplies if this is to their advantage.

The UK government has been broadly sympathetic to these concerns, but there remains a danger that these issues are not a high priority for the government and may therefore be conceded in negotiations with the Commission and other Member States.

2. Unrelated Trading Activities

Although the UK tax treatment of unrelated business activities carried on by charities is relatively generous when compared to that in many other countries, the charity sector has become more and more concerned that the need to establish a separate trading subsidiary company increases significantly the administrative costs of such activities. These costs arise because the subsidiary company is generally regulated by the same laws and accounting rules that apply to all non-charitable companies. To some extent the exemption of profits from small-scale trading activities introduced in the Finance Act 2000 has mitigated the problem but this relief will not necessarily be available in practice to the larger charities, and in any event it may be necessary to establish a separate trading company in order to comply with the requirements of charity law. Since such trading companies generally find it difficult to raise finance from third parties, it is usually necessary for the charity to provide the trading company with sufficient funds to finance its working capital requirements. In these circumstances, it is necessary for the charity to satisfy both the Charity Commission and the Inland Revenue, e.g. by reference to its business plans and budgets, that such an investment in the trading company is a secure and prudent investment of the charity's funds that is not likely to give rise to financial losses.

The charity sector has proposed that charities should be allowed to carry on unrelated business activities in their own name on a permanent basis without the need to set up a separate trading company for this purpose. While this would considerably reduce the compliance costs of a group structure, it is not clear that the tax efficiency of the group structure can be preserved with- in a single charitable entity. Since it would not be possible for the government to exempt from tax the profits on unrelated business activities without raising the issue of unfair competition with the private sector, and since the criteria for charity tax exemption are currently based on the purposes for which an organisation is established rather than the destination or application of an organisation's income, the scope for reducing the income tax liability on profits on such activities would generally be determined by the allocation of costs incurred by the charity between its unrelated business activities and its other activities.

3. Dividend Tax Credits

When the government completed its comprehensive review of the charity tax system in 1999, it rejected the two main concerns raised by charities, namely the issue of irrecoverable VAT and the reduction in charities' investment income resulting from the abolition in 1997 of the repayment to charities of tax credits on dividends received from UK companies. At the 1997 tax credit rate, this represented a reduction by 20% of the gross dividend income of charities; the cost to the sector has been estimated at £ 350 million a year. While the abolition of tax credit repayments remains a concern, it also applied to pension funds and was implemented as part of a broad reform of the UK corporate tax system. Consequently, any proposals for further changes in this area raise complex economic and political issues, and in this context the effect on charities is less likely to be given a high priority by government.

4. Gifts I Kind

The main benefit to the sector resulting from the charity tax review was the reform of the income tax incentives for gifts to charities in 2000. The removal of the limits on gifts of money, the simplification of the documentation required, and the new relief for gifts of listed shares and securities have all been well received, and the figures available to date suggest that these measures have led to a significant increase in tax-efficient charitable gifts. However, this success has to be viewed against a back- ground of a decline in recent years in the average level of charitable giving by both the general public and the business sector. Many charities believe that it is necessary to build on the reforms of 2000 by extending these tax reliefs to include gifts of unlisted shares and other gifts in kind in general.

5. Volunteers

Volunteers, including charity board members who are generally unpaid, have always made an important contribution to the UK charity sector. Currently the UK tax system provides almost no tax incentives for the use of volunteers, except for businesses seconding staff to charities on a temporary basis. However, there is no tax relief for the costs of voluntary work carried out by self- employed owners of businesses, whether sole traders or partners. Moreover, although charities can pay expenses to volunteers without any tax liabilities arising, these payments must meet strict documentation requirements and involve significant administrative costs.

6. Investment I PBOS

Traditionally, charities in the UK have sought to raise funds by asking individuals and businesses to give them money. Recent research suggests that there is scope for charities to offer their supporters "investments", such as bonds or fixed rate preference shares that yield less than a commercial rate of return. At present, there are no tax incentives available for such investments although such incentives could easily be justified as representing the middle ground between outright gifts to charity and commercial venture capital investments, both of which qualify for income tax reliefs.

7. Cross-Border Issues

Lastly, the UK tax reliefs for charities and gifts to charities are restricted to charities that are established and resident in the UK. This principle follows from a decision of the House of Lords in the case of Camille and Henry Dreyfus Foundation Inc. v. Commissioners of Inland Revenue [1955] (36 Tax Cases 126). Moreover, the Court of Appeal has held that a foreign charity that carries on charitable activities wholly or partly in the UK cannot register with the Charity Commission, since a foreign charity and its board members would not be subject to the jurisdiction of the UK courts (see Gaudiya Mission v. Kamalaksha DAS Brahmachary [1997] 4 All E.R. 957). There is no rule in UK domestic law which would allow tax reliefs to be granted to foreign charities on the basis of reciprocity. This situation is generally not relieved by any of the double tax treaties concluded by the UK. Although it is accepted that a charity can be a resident for the purposes of a tax treaty concluded by the UK, this only entitles a charity to claim the general treaty reliefs that are available to all taxpayers and not to claim the specific tax privileges that are granted to charities. As a matter of policy, the Inland Revenue does not seek to include specific charity tax reliefs when negotiating new tax treaties. Currently, the only such treaty that grants specific relief to non-UK resident charities is the treaty with Ireland, which grants Irish resident charities a limited exemption from UK tax on income and capital gains derived from real estate.

Accordingly, if a foreign charity derives income from the sale of goods and services in the course of carrying on its charitable activities or its fundraising activities in the UK, that income is potentially liable to *UK* income or corporation tax. Conversely, if a UK charity derives income from the sale of goods and services in the course of carrying on its charitable activities or its fundraising activities in another country, that income is potentially liable to foreign income or corporation tax.

The problem also exists in relation to cross-border gifts, but in practice to a lesser extent. Non-UK resident donors with sufficient UK source income to cover the gift can claim relief from UK income tax for qualifying gifts to UK resident charities. Moreover, in the reverse case of a UK resident donor wishing to make a donation to a foreign charity that has purposes that are charitable in UK law, it is possible for the UK resident to obtain tax relief if the gift is made to a UK resident intermediary charity, which then makes a grant to the non-resident charity equal to the amount of the gift less a service fee or commission. The UK charity must have complete authority over the disposal of the funds, and cannot act as a conduit. In theory, there is a risk that the UK charity could apply the gift to a different purpose than that selected by the donor, but in practice it is unlikely that any charity would be willing to risk losing the confidence of its donors. Since it is possible to establish a UK charity with "umbrella" purposes, i.e. purposes that cover the whole range of purposes that are charitable in UK law, it is not necessary to establish an intermediary charity for every type of charitable gift; in these circumstances, intermediary charities play an important role in the UK in furthering cross-border gifts.

III Description of 5 Main Points Suggested for Better Regulation and How to Implement the Suggested Recommendations

1. Vat Rebate Scheme

The charity sector is currently campaigning for the introduction in the UK of a rebate scheme to cover the cost of irrecoverable VAT relating to non-business activities. The proposal is for charities that have incurred such VAT to be able to apply for a central government grant to reimburse these costs. Because the grant would be limited to VAT incurred on non-business activities, the proposal should not give rise to any concerns about unfair competition with the private sector. The rebate scheme would not breach the EC 6th VAT Directive, since such schemes are a matter for Member States, and should not constitute illegal state aid since it would be available to all charities rather than on a selective basis. Such a scheme would also place charities on a level footing with local government authorities, which can reclaim VAT incurred on activities that do not compete with the private sector.

To reduce the administrative costs of such a scheme, it has been suggested that refund claims by and payments to individual charities could be processed by one or more intermediary charities with umbrella purposes (e.g. the Charities Aid Foundation).

2. Gifts in Kind

Since the current limited reliefs for charitable gifts in kind favour certain types of donor, it is reasonable to suggest that the reliefs should be available in principle to all gifts in kind. Such a measure would encourage in particular gifts to charity of unlisted shares, real estate, works of art, and depreciating property in private ownership such as computer equipment or motor vehicles. The main objection cited by the tax authorities is the difficulty of valuation, although such valuations are frequently required for other tax purposes where assets of these kinds are the subject of private gifts, e.g. to other members of a family.

3. Volunteers

The current system of tax incentives for charity supporters favours those who give money rather than their time. To encourage volunteers, it is suggested that they should be entitled either to claim a deduction from their taxable income based on the amount of time spent working on a voluntary basis or to receive a tax fee allowance from the charity to reflect the contribution of their time. Since it is intrinsically difficult to arrive at a fair value of an individual's time, it is likely that only a deduction or an allowance based on a flat hourly rate would be perceived as both equitable and acceptable to government. In addition, self-employed business owners, whether working alone or in partnership, should be allowed to deduct as a business expense the costs attributable to work performed for charities on a pro bono basis.

4. Investments in PBOS

Following the recommendations of a government-appointed task force, in March 2002 the government published draft legislation to introduce tax incentives for investment in charities, sometimes called social investment. The tax incentives take the form of an income tax credit for individual and corporate investors that contribute capital to Community Development Finance Institutions; these are collective social investment funds which are established to acquire portfolios of social investments in both for-profit and nonprofit enterprises. The tax credit will be grant- ed at the rate of 25% of the amount of the investment spread over 5 years. The draft legislation is expected to be included in the Finance Bill 2002. At the time of writing, it is too early to reach any conclusion as to the likely success of these incentives.

5. Cross-Border Issues

A strong case can be made for the extension of tax reliefs to charities that are resident in other Member States of the EU, and possibly the European Economic Area (EEA) as well, on the grounds that the present restrictions are in breach of at least two of the fundamental freedoms, namely the freedom of establishment and, subject to the right of Member States to retain pre-1994 restrictions, the free movement of capital. This will not necessarily be the case with all charities, since the definition of firms appears to exclude nonprofit organisations from the right of establishment, although it is suggested that the European Court of Justice would not support an interpretation that discriminated against an organisations engaged in economic activity. Moreover, the general prohibition on non-discrimination in Article 12 EC Treaty (reflected in Article 4 EEA Treaty) has previously been held by the EO to apply to nationality based restrictions on member- ship of Belgian associations (see Commission v. Belgium, Case C-172/98, decision of 29 June 1999). The UK and other Member States, most of which have similar restrictions on the grant of tax privileges to non-resident PBOs, may argue that these restrictions can be justified on the grounds that they are necessary to preserve the cohesion of the tax system (the so-called Bachmann defence after the decision in H.M.Bachmann v. Belgian State, Case C-204/90, ECR 92 (1) I 149), but it is difficult to accept that these restrictions are proportionate to the risk of abuse.

The extension of tax reliefs to charities resident outside the EEA is more difficult in the sense that there is no accepted mechanism for achieving this. Several states have included provisions to this effect in bilateral double tax treaties, but the objective of such treaties is to avoid double taxation rather than to grant double exemption from taxation, and it is the current policy of the OECD, as set out in its Model Income Tax Convention on Income and Capital 1992 and the Commentary thereon, that even the existing non-discrimination articles in such treaties should not be interpreted in favour of non-resident charities on the grounds that states derive no benefit from such measures. This approach is inconsistent with the grant of tax reliefs to domestic PBOs that carry out their activities abroad and is surely a narrow view of public benefit in an area of globalisation. However, since it is generally accepted by governments worldwide that the OECD has the prime responsibility for international policy in the field of direct taxes, and given an absence of political will in the OECD member states, it is difficult to see any possibility of change in this area in the short term.

The customary response of government authorities to complaints about such anomalies is to say that it is impossible to reconcile the differing concepts of charity around the world. But a comparative study of the meaning of public benefit in different countries on all continents will show that there is a substantial amount of common ground in the categories of activities that are accept- ed as being of public benefit. There is certainly no disagreement about the three main classes of public benefit activity: relief of poverty, relief of sickness and promotion of health, and education. And most states would accept the promotion of culture and the preservation of the environment. The fact that there are more controversial activities, notably in the field of religion and human rights, should not preclude agreement on other fronts.

The other main concern of governments is the scope for abuse. Hence the restriction of reliefs to domestic charities that can be held to account. This position can be supported as regards countries where there is no satisfactory mechanism for regulating the activities of PBOs, but it is more difficult to sustain where an adequate supervisory regime exists. In certain business sectors (e.g. collective investment schemes), it has proved possible for states to reach agreement that the prime responsibility for regulating companies operating in that sector should lie with the regulatory authority either in the company's home country or its host country. There is no reason in principle why a similar arrangement could not be developed for PBOs. In the meantime, there is scope for improving the use of domestic intermediary PBOs to facilitate cross-border donations by the development of a comprehensive international network of such organizations.

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Appendix C Tax Legislation Affecting the Not-for-Profit Sector in Germany

What follows is a brief outline of the basic corporate law and tax legislation affecting organizations in the German Not-for-Profit Sector. Not all the relevant differentiations and individual regulations will be considered. And, actual implementation of the regulations may vary depending on the particular circumstances.

I. Legal Forms of Business Organization

Not-for-Profit Sector organizations in Germany take various legal forms. The Association is most common. But, the Foundation and Joint-stock Company—and, to a lesser extent, the Cooperative Society—are increasingly popular corporate forms.

The variety of legal forms in the German Not-for-Profit Sector is largely the result of German tax legislation's neutrality as to legal form. The Corporation Tax Statute (Körperschaftssteuergesetz) extends tax benefits to all legal entities. Consequently, deciding which legal form to take depends not so much on the criteria of tax legislation as on the question of what organizational form most closely answers the founders' goals, the nature of the intended activities, and financing.

The fact that the Association is the most popular organizational form in the Not-for-Profit Sector is in part the consequence of a misunderstanding. Many people who establish a not-for-profit organization (NPO) believe that the Association is the simplest legal form available. In the course of their activities, corporate principals discover that the Association is actually an exceedingly complicated legal form, especially when the Association's activity diversifies. This is one reason why the last 15 years in the Not-for-Profit Sector has increasingly seen formation of subsidiary companies as tax-privileged Joint-stock companies.

1. The (Registered) Association

An Association is a union of members for a freely chosen lawful objective. The Bürgerliches Gesetzbuch (BGB) (German Civil Code) regulates associations. BGB contains regulations governing not only registered associations, but also unregistered associations, which have no legal standing.

Paragraphs 21 to 79 address: Articles of Association; the role of the management board and members' assemblies; and special requirements that apply to registered associations. Local magistrates' courts maintain a register of all official associations. A Notary must attest to any registration of an Association. The Magistrate then orders the registration.

To qualify for registration an Association may not have less than seven members. The Association is managed and represented by a Management Board [Vorstand]. The Management Board may consist of several members who, in most cases, serve in a voluntary capacity. But, the Association may employ its board and pay its members for their management work.

A registered Association must have a not-for-profit objective, but it may also engage in commercial or economic activities as a secondary purpose. The Association's liability is limited to its assets. An Association is not required to keep a balance sheet; a simple listing of receipts and expenditures, along with a rough listing of assets, is sufficient.

2. The Legally Recognized Foundation

A Foundation is an agglomeration of assets without members. A Directorate (board of curators or trustees) manages the Foundation. Like registered associations, the registered Foundation is subject to government inspection, which consists mainly in guaranteeing that the Foundation respects the wishes of the founding person(s). Inspection regulations differ in the various federal states of Germany. The current debate on reform of German law in this area focuses on how to apply these regulations to foundations.

Foundations with assets of less than €50,000 are, as a rule, not entered in the Register of Foundations, and so lack legal standing. More remarkable, however, non-registered foundations, which can be "hosted" by and administered "within" any other entity, receive tax benefits.

3. Joint-stock companies

3.1. The Private Limited Company (GmbH)

The Private Limited Company (GmbH) is a joint-stock company and, by definition, engages in commercial operations. It is managed and represented by one or more managing directors. Shareholder liability is limited to the company's share capital, which must be at least €25,000. As a trading company, regulations in the Commercial Code (Handelsgesetzbuch) govern the GmbH and, as a special legal form, the Limited Companies Act (GmbH-Gesetz). Shareholder interests in a GmbH may be terminated. In all cases, a departing shareholder must be bought out. If a shareholder (new or old) or the company itself does not take up the terminated shares, the GmbH must be dissolved.

3.2. The Public Limited Company (AG)

The Public Limited Company (AG) is also a joint-stock company and, by definition, engages in commercial operations. The AG's basic capital (nominal value of the share capital) must be at least €50,000. The Commercial Code (Handelsgesetzbuch) governs, as does the Companies Act (Aktiengesetz) with reference to its special legal form.

By contrast with the Private Limited Company (GmbH), the AG shareholder may not terminate participating interest without finding a buyer. A Management Board, which may consist of several members, manages and represents the AG. A Board of Directors (Supervisory Board or Aufsichtsrat) appoints and controls the Management Board. The Assembly of Shareholders elects the Board of Directors, which must have at least three members.

II. Basic Tax Legislation

1. Forms of Tax

German tax legislation comprises a wide range of tax forms. Corporation income tax, commercial earnings tax, and turnover/VAT tax are of interest in the present context.

1.1. Corporation Income Tax

Corporation Income Tax is one form of tax on profits. It is levied on a entity's profits at the rate of 26.5 percent. Associations benefit from a tax-free amount of €3835. Profits in one business year may be set off against losses in the previous year or subsequent years.

1.2. Commercial Earnings Tax

The Commercial Earnings Tax is a municipal tax, likewise levied on profits. The rate varies in the various municipalities of a federal state, but ranges between 15 and 25 percent. Again, associations benefit from a tax-free amount of € 3835. Losses may only be set off against profits from subsequent years. The Commercial Earnings Tax is accounted for as a business expense and reduces the net profit assessed by the Corporation Income Tax and the Commercial Earnings Tax itself.

1.3. Turnover Tax/VAT

The regular rate of Turnover Tax/VAT comes to 16 percent. For some specific products (foodstuffs, books, etc.) and services (local transport services, theater and concert functions, etc.), the rate is seven percent. A whole range of services is exempt from Turnover Tax/VAT. The exemption applies to services relating to education, health, and culture, fields in which Not-for-Profit Sector organizations are active.

2. Tax Privileges

Alongside the laws governing the various individual forms of tax—the Income Tax Act [Einkommensteuergesetz], Corporation Tax Act [Körperschaftsteuergesetz], Turnover Tax / VAT Act [Umsatzsteuergesetz], etc.—and the Code of Proceedings for fiscal courts, German law includes a special tax statute of general application, the Fiscal Code [Abgabenordnung]. The Fiscal Code defines: Basic concepts (tax, assessment, residence, business premises etc.); the tax power and obligations of persons liable for tax and their representatives; the procedures for levying taxes and compulsory enforcement; and tax penalties and fines. A separate section is dedicated to "tax-privileged objectives." This section contains 19 paragraphs (§§ 51 to 68), and describes the fundamental rules governing tax privilege. The specific effects of tax privilege, on the other hand, are described in the individual tax laws. The following integrates the fundamental principles of tax privilege and their specific effects in tax terms.

2.1. Tax-privileged Objectives

In accordance with German tax legislation, only entitys that come under the Corporation Tax Law and are based within Germany may claim tax privileges (there is an upcoming discussion, whether this conflicts with EU regulations to secure competition among EU based enterprises). This has two important consequences. First, unincorporated firms do not qualify for tax privileges. Second, all legal entities coming under the Corporation Tax Law—including the Association (registered or not), limited liability companies, Foundation (registered or not), and Cooperative Societies - qualify. The crucial factor is that these entitys should pursue objectives that are (i) of benefit to the community, (ii) charitable, or (iii) church-related, as defined by the Fiscal Code.

2.1.1. Objectives of Benefit to the Community

A entity pursues objectives of benefit to the community if, in the material, intellectual or moral sphere, it acts disinterestedly to promote the good of the general public. As special examples of objectives of benefit to the community, the Fiscal Code mentions among others promotion of:

- Science and research, education and training, art and culture, religion
- Good understanding between nations, development aid, environmental conservation, and the preservation of the national heritage
- Juvenile welfare, help for the aged, public health, social welfare, and sport
- Democratic political institutions in the Federal Republic of Germany
- Animal and plant breeding
- Carnival, amateur radio, and model airplanes

2.1.2. Charitable Objectives

A entity pursues charitable objectives if its activity is directed to the disinterested support of persons --

- Who, in view of their physical, mental, or emotional state are dependent on the help of others, or
- Whose earnings do not come to more than four times the regular rate of social assistance benefit and who own no assets that may be used to support them

2.1.3 Church-related objectives

A entity pursues church-related objectives, if its activity is directed to the disinterested support of a religious community, provided that this community is a entity under public law. Church-related objectives include, for example, church building and maintenance, religious instruction, the management of church assets, funeral services, and the care of funerary monuments.

2.2. Disinterestedness

Corporations that qualify for tax privileges are subject to the requirement of disinterestedness. They --

- Must use their resources in a limited period of time (e.g., within the year following the inflow of resources)
- May use their resources only for objectives in keeping with their articles of association
- May not pursue, as a prime aim, objectives tending to their own profit
- May not pay out any profits
- May not pay disproportionately high salaries

Shareholders of joint-stock companies that enjoy tax privilege and members of other tax-privileged entities may not, upon dissolution, receive more than the capital that they paid into it.

On dissolution, or if the objectives on which its tax privileges are based cease to exist, the entity's assets may only be used for tax-privileged purposes in so far as those assets exceed the sum of the capital shares paid into it. The assets may, to this end, be transferred to another tax-privileged entity, which in turn must use them for tax-privileged objectives.

If the Articles of Association do not plainly establish the asset restrictions just described, the organization receives no tax privileges. If the Articles of Association are revoked or modified in such a way that the required asset restrictions no longer exist, then it is as though they were absent from the beginning. As a result, the organization's tax privileges for the preceding ten years are revoked. This same fate befalls the entity that fails, in the course of its practical business activities, to adhere to asset restriction established in its Articles of Association.

2.3. Exclusivity and Immediacy

The tax-privileged entity must, in keeping with its Articles of Association, pursue tax-privileged objectives exclusively and from the outset. This means that the Articles of Association may not include any other non-tax-privileged objective alongside tax-privileged objective. And, the entity may not promote its objectives indirectly but must pursue them directly and immediately, unless they are engaged in "promotion of societies," an objective which may consist in supporting another tax-privileged entities. Foundations are likewise allowed to carry out their activities as a promotional foundation without themselves being active.

2.4. Formation of Reserves

Tax-privileged entities may form reserves if these reserves are necessary to enable the entity to pursue its objectives according to its Articles of Association. The reserves must be tied to a specific objective (e.g., the purchase of a building for purposes to do with the entity's objectives, financing of investments and projects, etc.).

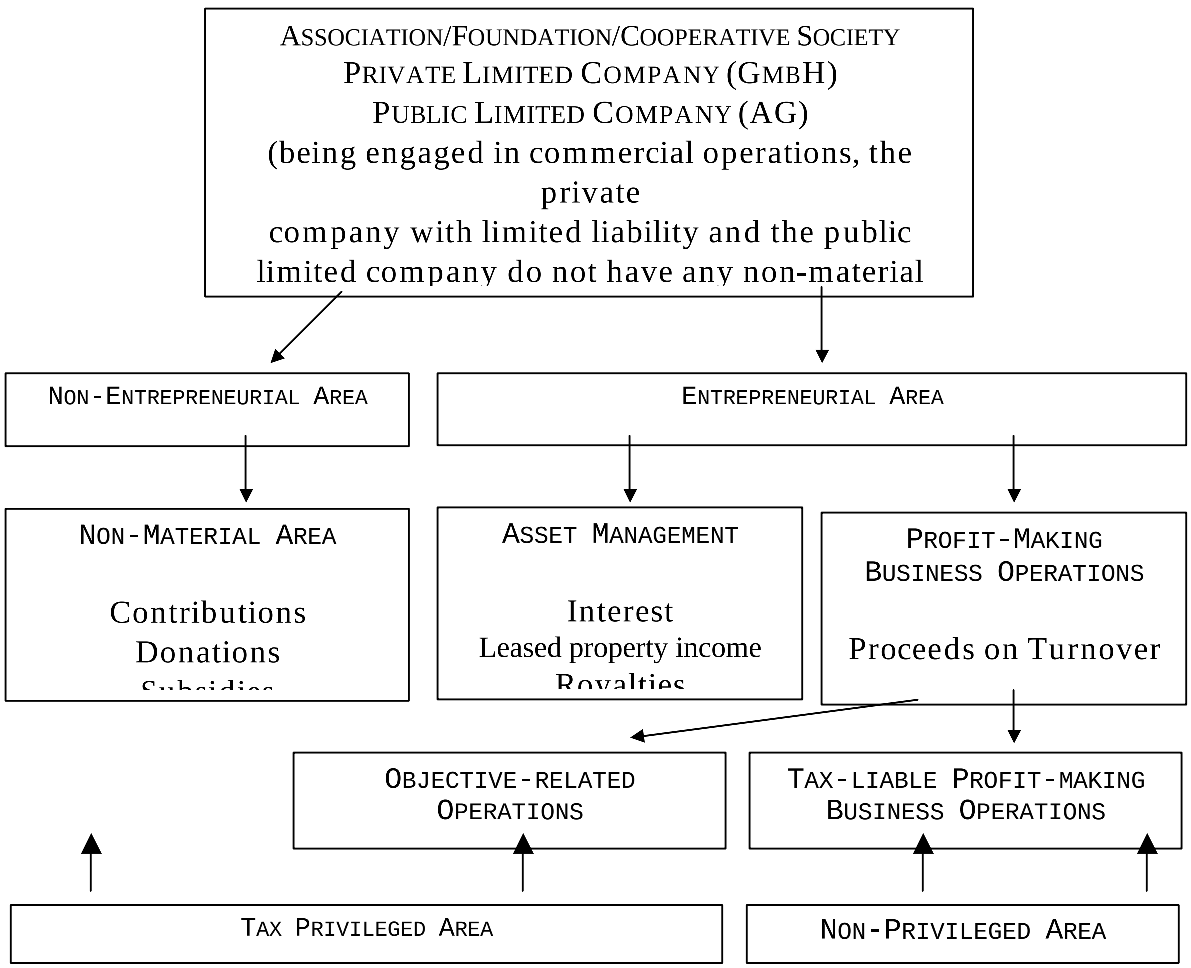
Tax-privileged entitys may also form "free reserves." These reserves are free in the sense that they need not be spent within a certain time period but can be kept until the entity is dissolved. Whenever the entity spends free reserves, it must spend them according to its statute. A tax-privileged entity may use free reserves to strengthen its assets and so that the short-term application of resources requirement does not apply to free reserves. The formation of free reserves is limited, however. In a single year, free reserves may consist of

- One third of the surplus derived from the management of assets, and

- Ten percent of the other resources that are to be used in the short term

2.5. Profit-making activities

Tax-privileged entities finance their activities from a range of different sources. Depending on the legal form, tax-privileged entities may use members' contributions, donations, subsidies, or yields on assets. As Not-for-Profit Sector organizations begin to act as service providers in the social and cultural spheres, remuneration for services rendered has become another important source of income. The following diagram shows the distinctions among the various forms of income of tax-privileged entities, in accordance with tax categories:



2.5.1 Areas of Activity of Tax-privileged Entities

i. The non-material area (ideeller Bereich):

Here the tax-privileged entity is active in keeping with the objectives set down in its Articles of Association and does not supply any services for payment. It receives members' contributions, donations, and subsidies, which it spends in the fulfillment of its constitutional objectives. For associations, this is the area that may be represented through a simple accounting of income against expenditure.

ii. Asset management (Vermögensverwaltung)

With asset management, the tax-privileged entity receives tax-exempt interest as well as profits from renting or leasing property (immovable assets) and even from the use of its own name (royalties). From the Turnover Tax/VAT perspective, the tax-privileged entity is considered entrepreneurial in the asset management context. And, to the extent the tax-privileged entity's activities are subject to Turnover Tax/VAT, its tax rate falls (currently to seven percent).

iii. Profit-making business operations (wirtschaftlicher Geschäftsbetrieb)

When engaged in profit-making business operations, a tax-privileged entity obtains payment (turnover) for the services it supplies. Through its profit-making business operations, the tax-privileged entity participates in the economic marketplace and competes with for-profit entities. How the German tax law treats the profit-making business operations of tax-privileged entities depends on whether the given profit-making business operation can be seen as an "objective-related operation." Objective-related operations are privileged, both for income tax and for Turnover Tax/VAT purposes. Profit-making business operations that are not objective-related operations are taxed as non-tax-privileged enterprises.

2.5.2 Objective-related Operations (Zweckbetrieb)

Section 65 of the Fiscal Code defines objective-related operations. To qualify, the tax-privileged entity's profit-making activity (1) must support the tax-privileged entity's objective as expressed in its statute, (2) must be necessary to fulfill its statutory objectives, and (3) may compete with non-tax-privileged entities only to the extent that this is unavoidable for the fulfillment of its not-for-profit objectives. Because discriminating between objective-related operations and profit-making business operations is difficult, there are frequent disputes in this area.

Objective-related operations are, for example:

- Entrance fees charged by an arts organization for its cultural functions
- Workshop attendance fees charged by a society for the promotion of professional training
- Fees charges by the Jugendhilfe GmbH (Juvenile Welfare Co. Ltd.) of the municipal juvenile welfare authority for help and counseling given to young people (such operations may not be financed through subsidies, as the individual young person has a statutory or legal claim for assistance and the municipal juvenile welfare authority has commissioned the Jugendhilfe GmbH to give counseling)
- Fees charged in a restaurant run by a society that looks after the interests of people suffering from mental illness (but only if the restaurant is operated for the sole purpose of giving the society's clients an opportunity of work for therapeutic ends)

In its objective-related operations, the tax-privileged entity is exempt from Corporation tax and Commercial Earnings tax and the Turnover Tax/VAT rate reduction applies. Some objective-related operations are completely exempt from Turnover Tax/VAT (educational functions, objective-related operations of welfare syndicates and their member organizations, if their services are supplied at a lower fee than those supplied by non-tax-privileged providers).

2.5.3 Taxable Profit-making Business Operations

Depending on the activity, tax-privileged entities are subject to Corporation and Commercial Earnings taxes, with Turnover Tax/VAT rates applying at the current regular tax rate. Activities subject to taxation are too numerous to classify. Some examples include: The bar of a sports club; the provision of rental cars; drawing up expert reports; and holding of bazaars and lotteries. The following points, however, are noteworthy:

- If the income from taxable profit-making business operations does not exceed €30,678, no Corporation or Commercial Earnings tax will be levied
- German law allows associations, cooperative societies, and foundations to deduct €3835 from profits subject to Corporation and Commercial Earnings on the basis of their legal form

2.5.4 Subsidiary Companies of Corporations that Benefit the Community

Tax-privileged entities may also have a participating interest in a joint-stock company, including one that is not tax-privileged. The participating share is allocated to asset management, provided that its tax-privileged parent company does not exert a determining influence on the joint-stock company's concrete business decisions. Formation of subsidiary companies is a sensible move for an Association if (1) its legitimate objective-related operations become too large for the Association to handle (because the subsidiary company will be a tax-privileged company), or (2) the extent of taxable activities threatens its tax privileges.

In forming a subsidiary company, the most important question is where the tax-privileged parent company has obtained the resources to establish a subsidiary company. The tax-privileged entity may only use its own resources if they have already been put into a free reserve fund. Tax authorities do not enforce this technicality too strictly except when the subsidiary company formed is not tax-privileged.

3. Donations and Sponsoring

Currently, as government reduces spending, tax-privileged organizations are increasingly coming to depend on private resources to finance their activities. Therefore, fiscal encouragement of private donations to develop capacity of the entire sector of tax-privileged entities increases in significance. However, in the German income tax system, donations reduce taxable income only to a limited extent.

At present the following regulations apply to donations:

- In the case of donations for church-related, religious, scientific, and charitable objectives and objectives especially deserving of support that benefit the community, up to five percent of the total amount of taxable income, or two percent of the sum deriving from turnover and personnel costs, may be claimed as tax-exempt

- In the case of donations for charitable and scientific objectives and cultural objectives that are especially deserving of support, the exemption is increased by another five percent of the total amount of taxable income
- Individual donations of at least €25,565 may be spread out for tax purposes over a period of seven years
- In the case of donations to tax-privileged foundations, up to €20,450 may be deducted from tax
- In addition, in the case of donations that are paid into the assets of a foundation on the occasion of its being set up, up to €307,000 may be spread out over a period of ten years

With sponsorship, the rule is different. While a donor gives a donation on the understanding that the donee should supply no service to the donor in exchange for the donation, sponsorship—according to German tax law—implies payment in exchange for service. The sponsor, therefore, incurs a business expense. This might be in the sponsor's interest, as the business expense—unlike the donation—reduces taxable profits to the full amount.

When a tax-privileged entity is involved in a sponsorship relationship, German tax law recognizes various forms of income. For example,

- If the tax-privileged entity supplies the sponsor with a service in the form of promotion, then the service is a taxable profit-making business operation. In this case, a flat rate totaling 15 percent of the sponsoring sum will be considered as taxable profit. In addition, Turnover Tax/VAT at the regular rate (currently 16 percent) will be assessed.
- If the sponsor pays the tax-privileged entity in exchange for a license to use the tax-privileged entity's name or logo, then the tax-privileged entity's relevant income is allocated to asset management. There is no Corporation or Commercial Earnings tax liability, and the reduced Turnover Tax/VAT will apply. To transform taxable income from promotion into tax-privileged income from asset management, the tax-privileged entity may, for a fee, transfer the tax-privileged promotional rights to an advertising agency as an intermediary. The advertising agency will then, in its own name and at its own risk, contract with the individual companies involved. The tax-privileged entity will charge the company for the transfer of rights and receive tax-privileged royalties, while the same royalties will reduce the taxable income of the company.

III. Concession and Control of Tax Privileges

In Germany the responsible tax office is solely responsible for the concession and control of tax privileges. There is no separate procedure in German tax legislation to determine a right to tax privileges. The appropriate tax office determines the right to privileged tax treatment in the course of regular tax assessment. In place of a tax assessment for entity and commercial earnings tax, the tax-privileged entity will receive a "notification of exemption." This notification exempts the entity from taxes due. If the tax-privileged entity is also liable for Corporation and Commercial Earnings taxes because of its taxable business operations, it will receive the usual tax assessment along with an annex stating that in other respects it is exempt from these taxes.

As tax demands can only be remitted for trading years that have expired, the tax privilege in question will in all cases be granted only retrospectively. For the first (and generally for the second) trading year, the entity will receive a "Provisional Certificate." This certificate establishes only that the entity is pursuing tax-privileged objectives in accordance with its Articles of Association and that it is entitled to make out donation certificates with effect on its tax liability.

Tax-privileged entities are obliged to draw up statements of their end-of-year accounts. The form of these accounts is based on the legal form of the entity. In addition to these accounts, tax-privileged entities are obliged to submit reports on their activities for each trading year, from which it is determined whether the tax-privileged entity has attained its constitutional objectives.

To make matters easier for tax-privileged entities, an assessment of tax liability (or possible exemption) is generally made for such entities only every three years. In view of the risks to which commercially active tax-privileged entities are exposed, however, they typically submit annual tax statements and thus receive annual notifications of exemption as well.

During the tax assessment period (four years), the tax office may audit the tax-privileged entity, in the course of which the auditing tax office will re-examine the basis for tax-privileged status. As a result of these audits, the tax office may change the tax status of tax-privileged organizations to their disadvantage. The tax office may even revoke tax privileges retrospectively.

VI. The Significance of Tax Privileges for The Third Sector

The majority of Not-for-Profit Sector organizations in Germany is tax-privileged and they try to conform to the criteria that will enable them to retain their privileges. With the shift in the basis for financing, especially for organizations in the cultural and social sectors, Not-for-Profit organizations' attitude towards tax privileges is also changing. Government withdrawal from financing cultural projects and diminishing governmental subsidies for social work projects have forced many organizations into cooperative partnership with commercial companies that see sponsoring of culture and social causes as a new opportunity for communicating with and acquiring customers. A partnership with commercial companies, however, is possible for a tax-privileged entity only to the limited extent the partnership does not endanger their tax privilege. In particular, organizations in the cultural sphere are increasingly inclined either to work in twin structures of tax-privileged and non-tax-privileged entities or to decide at the very beginning against applying for tax-privileged status. In the social sector, similar tendencies are now evident. The future of tax privilege in Germany will therefore depend on the way in which the conditions change for financing projects in the fields of activity relevant for Not-for-Profit organizations. Here the foremost question will be whether the extension of the fiscal recognition of donations can more effectively compensate for the reduction in governmental spending than can an increased cooperation between Not-for-Profit organizations and the commercial sector. It will also be significant to see whether tax-privileged organizations continue to dominate cultural and social services or if, in the course of deregulation and other economic measures, the private commercial sector gets involved.

Appendix D Tax System for NPOs in Japan[*]

Legal Description of the NPO Sector in Japan. . At the current time there are ten different legal forms that are used by Japanese NPOs to obtain legal personality.[128] Prior to the legal reforms introduced in 1998, it was quite difficult to establish an NPO. Under provisions of the Civil Code of 1896, Public Interest Legal Persons (associations and foundations) (PILPs) were and continue to be required to receive permission from the ministry with oversight over their activities in order to register. Similar rules were and continue to be applicable to other kinds of entities, such as Private School Corporations and Social Welfare Corporations. Although these legal forms still exist, the creation of the "NPO" Legal Person pursuant to legislation adopted in 1998 and amended in 2002 has simplified the registration process by requiring only that NPO Legal Persons be "certified" by the Economic Planning Agency. Many more NPOs have been registered as a result of the new law, which came into effect in response to the Kobe (Great Hanshin) Earthquake. An important issue under debate in Japan is whether the entire PILP structure should be scrapped entirely, in favor of a simpler approach.[129]

Income Tax Exemption and Special Internal Tax Deduction. Under Japan's Corporation Tax Law, Articles 4 and 7, PILPs are exempt from corporate income tax except to the extent they receive income from profit-making activities. There are 33 specific types of profit-making activities listed in the law, and for those the tax rate is only 27% (as opposed to the 37.5% rate imposed on the income from those activities when they are performed by for-profit corporations). In addition, PILPs are permitted to take a special "internal" tax deduction —they are allowed to deduct up to 20% of income from profit-making activities from their taxable income to the extent the funds are used to expand their core public interest activities.[130]

Special rules are applicable to non-Civil Code organizations such as Social Welfare Corporations, Private School Corporations, and Religious Corporations. These are also subject to favorable tax regimes that are similar to that applicable to PILPs, but the rules differ for each. For example, such specialized organizations may deduct the greater of 50% or ¥ 2 million of the income earned from their profit making activities if the revenues are devoted to their public interest activities. Medical corporations, on the other hand, do not enjoy the same kind of tax treatment as do PILPs. They are taxed like for-profit corporations, at the full corporate tax rate, except to the extent they receive medical fees as reimbursements by the social insurance system. The exception applies to "Special Medical Corporations" (*tokutei iryo houjin*) that the Ministry of Finance has certified as being especially in the public interest. Such "Special Medical

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[*] The discussion in this paper is drawn primarily from Robert Pekkanen and Karla Simon, "The legal framework for voluntary and nonprofit activity" in THE VOLUNTARY AND NON-PROFIT SECTOR IN JAPAN (Stephen P. Osborne, ed.) Routledge-Curzon, London, 2003.

[128] These include the Public Interest Legal Person (PILP), which is broken down into associations and foundations; the Social Welfare Legal Person; the Educational (Private School) Corporation; the Religious Corporation; the Medical Corporation; the Public Charitable Trust; the Approved Community-Based Organization; the NPO Legal Person; and the Mutual Benefit Legal Person.

[129] See discussion Update on NPOs in 1 Intl J. Civil Soc. L. 4 at 128 ff. (October 2003)

[130] This special "internal" deduction is now available to special kinds of NPOs. See text below.

Corporations" are taxed at 27% and receive some tax exemptions (e.g. tax on real estate acquisitions for nurses' training facilities).

In general, income tax exemption is not available for NPOs organized under the 1998 legislation.

Application of and exemptions from indirect taxes. PILPs are subject to consumption tax (e.g., VAT), other indirect taxes, and local taxes. They may be exempt from local taxes only if their main purpose is the establishment of a museum or the pursuit of studies. PILPs are exempt from several other types of taxation including taxation of the interest earned on endowment funds. These benefits are significant, but they are available only for PILPs organized directly under the Civil Code Article 34 and not for other organizations, such as NPOs.

Income and Inheritance Tax Deductibility of Charitable Contributions—Rules specifying limits. Qualifying contributions from corporations or individuals to PILPs may be deducted in certain situations, but the circumstances under which these contributions qualify for deduction is limited. Moreover, the availability of tax deductibility is left to a considerable extent to the discretion of the Ministry of Finance.

Charitable contributions are deductible if they are made to organizations designated by Income Tax Law 78 (2)-[2] as "Special Public Interest Promoting Corporations" (*tokutei koueki zoushin houjin*) (or to designated purposes, *shitei kifukin*) of regular PILPs. These "Special Public Interest Promoting Corporations," or *tokuzou* as they are commonly known, include 26 corporations based on Special Laws and closely linked to the government. These include the National Institute for Research Advancement and the Japan Foundation, as well as all Social Welfare Corporations and Private School Corporations. PILPs organized under the Civil Code can be added to this list by being certified by the Minister of Finance, and almost 900 have obtained the proper certification.

Individuals' contributions of up to one quarter of their annual income over a floor of 10,000 yen (about $100) are deductible. Corporations contributing to *tokuzou* can do so up to limits determined by a formula (1.25% of income plus 0.125% of paid-in capital). The total number of organizations that could receive a deductible charitable contribution under the Income Tax Law prior to the 2001 reforms was about 17,000 (see Table 1).

Bequests to Special Public Interest Promoting Corporations are also deductible from inheritance taxes within specific limits.

Table 1: Special Public Interest Promoting Corporations (1996)[131]	
PILPs incorporated associations (*shadan houjn)* and foundations (*zaidan houjin)*	822
Private School Corporations	1125
Social Welfare Legal Persons	14,832
Other	189
Total	**17,026**

Tax Reform Measures for NPOs. In the Fiscal Year 2001 Tax Reform, provisions were introduced to allow certain Specified Nonprofit Activities Legal Persons (NPOs) to gain the

[131] Data from Naoto Yamauchi *NPO deetabukku* p. 89.

status of “Tax-Deductible ("*nintei*") Specified Nonprofit Activities Legal Persons” (hereafter, Tax-Deductible NPOs). These provisions were enacted on March 31, 2001 and came into effect on October 1, 2001.[132]

Applicants for the status of “Tax-Deductible NPO” must be NPO Legal Persons under the 1998 legislation and be certified by the Commissioner of the National Tax Administration as having satisfied a list of requirements detailed below. It is important to note that although this new law permits deductible contributions to be made to the Tax Deductible NPOs, the contribution limits set out in the Income Tax and the Corporation Tax, discussed above, were not increased. Bequests to Tax Deductible NPOs are also deductible from inheritance taxes, but Tax-Deductible NPOs are not exempt from national or local taxation, as are PILPs.

Nevertheless one provision included in the 2002 changes in the rules applicable to NPOs places them on an equal footing with PILPs with regard to taxability of their income from profit-making activities. The special “internal” tax deductible donation (*minashi kifukin*) recognized in the PILP system is now applicable to NPOs. Up to 20 percent of an NPO's taxable income from profit-making activities may be treated as deductible if it is used to accomplish the public benefit activities of the NPO.

In response to complaints that the provisions for determining eligibility for tax-deductible status for NPOs were overly restrictive and that the application process was cumbersome and confusing, the law was again amended in 2002, with effect from April 1, 2003.[133] The following discussion of the provisions applicable to tax deductible NPOs takes into account the 2002 changes.

Qualifying for Tax-Deductibility as an NPO Legal Person

Activity Restrictions/Self-dealing Rules. There are certain restrictions on activities if an NPO is to qualify for tax deductibility. Religious or political activities are not permitted. Provisions designed to prevent Tax-Deductible NPOs from being used as front groups prohibit special relationships with specific persons, contributions to corporations, religious groups, or political groups. Rules also prohibit the distribution of profits to directors, employees, contributors or their relatives. Similarly, no more than 1/3 of employees or directors may be members of the same family nor may 1/3 of directors or employees (as well as their relatives) be employees or directors of another related legal person or group

Expenditure Restrictions. At least 80% of expenditures and at least 70% of all contributions must be spent on Specified Nonprofit Activities (meaning those activities for which organizations may be formed and receive legal status as NPO Legal Persons. To be able to fit within the tax-deductible class NPOs must make available to the public and also provide to the

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132 The provisions of the 2001 law can be found on the Ministry of Finance website: http://www.mof.go.jp/genan13/zei001g.htm. The provisions of the 2002 amendments are included in the paper.

133 According to an article in Civil Society Monitor, published on the website of the Japan Center for International Exchange (JCIE), “after more than one year, only 10 NPOs had been authorized to receive this tax privilege, representing an authorization rate of 0.1percent.” http://www.jcie.or.jp/civilnet/monitor/8.html.

National Tax Administration the criteria, methods, and names of individuals by which or by whom grantees will be solicited and evaluated. Actual funding decisions must be treated in the same way. Except in times of emergency when notification may follow, transfers of funds overseas must be noticed in advance, including date, amount, and recipient. Strict accounting standards are spelled out for Tax Deductible NPOs.

Public Benefit Tests. There are two public benefit tests,[134] which must be met for an NPO to qualify. The first test includes four provisions designed to prohibit mutual benefit organizations from qualifying. For example, more than half of the activities must not be services or funds for the benefit of members. Nor may more than half of the Tax-Deductible NPO's activities be for exchange, contact, exchange of opinions, etc. among members.

The second public benefit test is the public support test. An accounting formula is provided to determine that at least 1/3 of the group's total revenue comes from public support via contributions. This percentage is reduced to 1/5 for a trial period beginning in 2003 and ending in 2006. Both revenue and public support are defined in detail. Revenue does not include such items as government funding (*hojokin*). Contributions from any individual (or his or her relatives) or a related legal person will only count towards the public support total to 5% of total contributions. This prohibits the organization from having a single large donor count towards its public support. Contributions from directors, employees, and their relatives only count towards public support under certain conditions. Only contributions of ¥1000 (about $10) or more count towards the public support total.

Procedure for obtaining tax deductible status for NPOs. The Commissioner of the National Tax Agency makes the determination of tax-deductible status for NPOs. This official can also investigate the organization to make this determination (or to consider its removal from the list.

Reporting duties for Tax Deductible NPOs. Organizations must file reports every year (within three months of the year's end) with the National Tax Administration. The National Tax Administration will permit public access to these documents for three years. The following documents are required to be filed: documentation of funding (sources and amounts of income, amount of borrowing); lists of activities and services, charges, and objects of provision; list of parties engaged in transactions of ¥ 500,000 or more a year with the Tax-Deductible NPO, their names and the amounts; conditions for membership, membership fees, recruiting scope, and numbers of members residing in different geographic areas (administrative units); specific accounting of activities engaged in with the contributions (including planned activities), scope and methods of collection of contributions; contributors' name, address, and amount given; names and compensation of employees; copies of all documents submitted to the permitting agency that granted the Tax-Deductible NPO its status as an NPO Legal Person. This agency must also attest that the NPO Legal Person has not violated its own charter or the law.

The requirement stipulating that NPOs approved for tax deductibility must submit advance notification to the National Tax Administration Agency before making overseas remittances or taking money abroad has been amended. Now, notification is only required for amounts exceeding ¥ 2 million (Amounts equaling ¥ 2 million or less can be reported to the agency at the end of the fiscal year.)

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[134] A third geographic test was repealed in 2002 so as to make it possible for local community-based groups to be eligible for tax deductible status.

Applicable provisions of the 2002 Tax Reform Law (unofficial translation).

"The following revisions have been introduced to the system regulating the Approved Specified Nonprofit Corporations eligible for tax-deductible contributions.

1. The conditions for the approval of Specified Nonprofit Corporations shall be as follows.
    - i. Measures relating to the public support test (total amount of donations and grants shall make up more than one-third of the total amount of income) are as follows:
        - a. For the period between April 1, 2003, and March 31, 2006, the ratio shall be eased to more than one-fifth (specified as one-third under the present law in force) the total amount of income.
        - b. The standard limit per donor not to be counted toward the amount of donations received shall not exceed five (5) percent of the total amount of donations received (presently set at two (2) percent).
        - c. The standard limit per donor not to be counted toward the total amount of income and the total amount of donations received shall be lowered to under 1,000 yen (presently set at 3,000 yen).
        - d. The amount of commission grants received from national or local governments and international organizations in which Japan is a member or the amount of subsidies received from international organizations in which Japan is a member shall not be counted toward the total amount of income.
    - ii. The conditions for approval relating to operations of specified nonprofit corporations conducted in more than one municipality are to be repealed.
    - iii. If the said corporation remits or transfers money overseas, it shall submit documents beforehand to the National Tax Administration Agency for the amount exceeding 2,000,000 yen. For the amount equaling 2,000,000 yen or less, the information on the said remittance or transfer of money shall be submitted after the termination of the fiscal year.

The amount used for specified nonprofit activities from assets obtained from revenue-generating operations shall be deemed to be donations and the percentage limit of tax deductible amount for said donations shall be twenty (20) percent of the profit. "

Appendix E Survey of Tax Laws Affecting NGOs in The Newly Independent States*

Introduction

This report surveys current tax laws governing not-for-profit, non-governmental organizations ("NGOs") in twelve Newly Independent States of the former Soviet Union ("NIS"). Specifically, this report covers Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Uzbekistan, and Ukraine. The report is based on responses to a survey questionnaire regarding tax laws and regulations pertaining to NGOs provided by experienced attorneys in each of the subject countries.

Section I of this report summarizes the tax treatment of NGOs in the NIS. Section II compiles survey responses for each country, providing information on income/profits tax exemptions for NGOs; the tax treatment of income from NGO economic activities; the applicability of other taxes, such as the Value Added Tax (VAT) and taxes on real property; as well as incentives for individual and corporate philanthropy. Section III of this report contains charts encapsulating the foregoing information.

The purpose of this publication is not to provide legal advice or to present a comprehensive analysis of taxes in NIS; rather it is to provide the reader with a comparative perspective on the situation concerning the taxation of NGOs in this region.

Overview of Tax Laws Affecting NGOs in the Newly Independent States Region

After the collapse of the Soviet Union, the Newly Independent States granted benefits and freedoms to freshly privatized government-organized NGOs or "GONGOs." Extensive tax benefits, however, were eliminated as soon as more independent self-governing NGOs started to appear. The survey reveals that since the end of the "golden age for a few" most countries in the region have made some progress towards modernizing their tax laws and creating an enabling fiscal environment for NGOs. For example, in all countries donations, entry and membership dues are tax-exempt for at least some types of NGOs. The most remarkable progress has occurred in Ukraine, Kyrgyzstan, and Kazakhstan, where a broad variety of organizations are benefiting from tax exemptions provided on income from a variety of sources. However, in several countries, tax legislation has deteriorated. For example, in Russia the 2000 Tax Code eliminated benefits previously provided to NGOs. Other countries, like Belarus and Turkmenistan, have not progressed in recent years.

The survey reveals the need for further reforms of the existing tax laws in order to ensure the continuing financial sustainability of NGOs in all NIS countries. This overview will discuss the trends in taxation of NGOs in the region.

1. The Types of Organizations Permitted to Seek Tax Exemption.

* This report is the Introduction to the "Survey of Tax Laws Affecting NGOs in the Newly Independent States "published by ICNL on its website www.icnl..org. Copyright © ICNL 2003.

In all countries NGOs are considered taxpayers of profits (income) tax. For example, Kyrgyzstan and Ukraine provide that only legal entities whose activities are for the purposes of obtaining profits or that are carrying out economic activities are considered taxpayers. However, the notions of "activities aimed at obtaining profits" or "economic activities" are defined so broadly that even maintaining a bank account may bring an NGO into the ambit of this law.

In establishing the legal requirements for tax-exempt status, some countries extend the exemption to different types of organizations (*i.e.*, foundations, associations, and other types of not-for-profit legal entities)[135] provided that they are duly registered, they adhere to the non-distribution constraint, and they have primary goals other than obtaining profits.[136] In Ukraine, for example, the profits tax law establishes eight categories of nonprofit organizations which enjoy various types of benefits.

Most countries establish "charitable organizations" but do not provide them with "special" tax treatment. Laws in most countries (with the exception of Kazakhstan, Belarus, and Turkmenistan) define "charitable" ("public benefit") organizations either in a special law (Armenia, Kyrgyzstan, Ukraine, Moldova, Russia and Tajikistan), or in the tax code (Georgia, Kyrgyzstan, Azerbaijan and Ukraine). Only Moldova provides "charitable organizations" with benefits that are greater than the benefits for other NGOs. In some countries (for example, in Georgia) benefits related to "charitable organizations" are more difficult to implement in comparison with benefits for other NGOs as the laws lacks clear procedures for identifying charities.

Organizations of the disabled enjoy special status entitlements in most countries, including greater tax benefits, if they meet certain legal requirements.

Some countries, for example, Turkmenistan, Belarus, and Uzbekistan, reserve special benefits for NGOs specifically named in the tax laws, in addition to general benefits which are accessible to a broader category of NGOs. These are usually "all-national" GONGOs often left over from the Soviet era and subsidized from the state budget.

2. The Sources of Tax-Exempt Income.

2.1 Taxation of Revenues Obtained on Gratuitous Basis

All countries in the region treat income from grants, donations, fees and dues as tax-exempt. Sometimes imprecise definitions impede the applicability of these benefits. For example, it was a challenge for Kyrgyz NGOs to claim an exemption for "humanitarian assistance" and "grants" until these terms were more fully defined in amendments to the tax code of March 2003.

Several countries (Georgia, Azerbaijan, Kyrgyzstan, Kazakhstan, Russia, and Ukraine)

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[135] The three most common organizational forms used to establish NGOs in the region are the association, the foundation, and the institution, although several countries authorize other forms. For example, Kazakhstan allows NGOs to be incorporated as joint stock companies.

[136] The nondistribution constraint prohibits an NGO from distributing its profits, as such, to any person. Thus, all profits must be used to support the NGO's operations. This feature distinguishes NGOs from for-profit businesses.

specifically distinguish between grants and donations. While the definition of grants varies, generally, these countries require that a grant must be provided for a specified purpose, and that there must be a written agreement between the donor and the recipient. Two countries, Georgia and Azerbaijan, even have special laws regulating grants. In some countries, donations or grants from local and foreign donors are treated differently, with a greater scrutiny for foreign donations (for example, in Belarus, Azerbaijan, and Kazakhstan).

2.2 Taxation of Income from Entrepreneurial Activities

In most countries, carrying out entrepreneurial activities is permitted for all NGOs. The only exceptions are Armenia and Ukraine, where public associations are permitted to carry out economic activities only through a separate subsidiary, although in Ukraine, this requirement is not enforced.

In all countries, NGOs can carry out only those entrepreneurial activities that relate to (or help to advance) their statutory purposes. An NGO that carries out unrelated economic activities as a rule does not lose exempt status. However, the profits generated through such unrelated activities are subject to a tax at the general rate.

While in most countries income from entrepreneurial activities is taxed at the general rate applicable to legal entities, some countries exempt income from such activities from profits tax, provided certain requirements are met. For example, in Kazakhstan, the income of "social service organizations" is exempt from profits tax if such organizations derive no less than 90 percent of their gross annual income from the provision of services or conduct of activities in enumerated fields specified in the tax code (healthcare, child care and education, science, sports, culture, library services and social welfare).[137]

In Georgia, income from scientific and educational activities, even if obtained through sales of goods or services, is exempt from profits tax, as are all other incomes of non-entrepreneurial organizations from charitable activities.

In Ukraine, the notion of income from "primary activities" which is exempt from profits tax for charitable organizations and public associations, also includes income from some entrepreneurial activities as long as they are related to statutory purposes of an NGO. "Primary activities" are charitable activities, provision of educational, cultural, scientific, informative and other similar services for public consumption, and provision of services in connection with the establishment of the social security system (pension funds, credit unions and similar organizations). Additionally, "primary activities" include the sale of goods and services that promote principles and ideas for which the NGO was established and which are closely related to its primary activities, provided that the price for such goods and services is lower than the market price or subject to state regulation.[138]

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[137] Section 121 (1) of the Tax Code of the Republic of Kazakhstan as of June 12, 2001 (with subsequent amendments as of August 1, 2003.)

[138] Section 7 (11) (13) of the Law on Taxation of the Profits of Enterprises of Ukraine, as of December 28, 1994 (with subsequent amendments as of December 24, 2002).

A different approach to exemption of income from entrepreneurial activities has been chosen in Uzbekistan, where one hundred percent of income generated from an entrepreneurial activity of a business subsidiary set up by a public association is exempt from profits tax if transferred back to the public association.

2.3 Exemptions for Passive (Investment) Income

Most countries in the region tax the passive income of NGOs at a general rate. The only exceptions from this rule are Ukraine, where revenues received as interest, dividends, insurance benefits and indemnities, as well as royalties[5139] are exempt from profits tax for all types of NGOs; and Kazakhstan, where NGOs are exempt from taxation of "premium," defined as interest earnings from loans, bank deposits, and debt securities (discount or coupon), as well as financial leasing payments, payments for property transferred into trusts, and payments under certain insurance agreements.[140] In Armenia and Kyrgyzstan certain passive incomes (for example, dividends and interest from privatization certificates) are exempt from profits tax for any recipient of such income, either an NGO or a business. In Azerbaijan, the tax code provisions are not clear and are implemented inconsistently on whether passive income for NGOs is exempt.

None of the countries in the region have laws which specifically address the creation of endowments or taxation rules for income earned from endowments. The concept of an endowment as a means to finance grantmaking has not, by and large, taken hold in the region.

2.4 Value Added Tax (VAT)

All countries in the Newly Independent States region impose a value added tax upon the sale or transfer of goods and services including imported goods. None of the countries exempt NGOs per se from VAT. However, in most countries the majority of NGOs fall under the registration threshold for VAT. For example in Ukraine the threshold is $11,500 for twelve consecutive months. In Georgia the threshold is $14,000. An NGO that does not register need not collect and pay VAT on goods and services that it provides and thus does not incur compliance costs (*i.e.*, for accounting and reporting). Unfortunately, it is unable to obtain rebates for the VAT that it pays for goods and services. As a result, this is not an approach that is particularly beneficial to NGOs.[141]

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[139] Id.

[140] Section 10(1) (2) of the Tax Code of the Republic of Kazakhstan as of June 12, 2001 (with subsequent amendments as of August 1, 2003.)

[141] *See* International Center for Not-for-Profit Law, "Economic Activities of Not-for-Profit Organizations," in *Regulating Civil Society*, conference report, Budapest 1996, at Appendix I –Value Added Tax (VAT) [reprinted at www.icnl.org]; Tax Preferences, *supra* note 4..

Another option is to "zero-rate" goods and services. Under this option, an NGO must pay the VAT on goods and services that it purchases, but it may seek rebates for those amounts. This is generally considered a preferable option for NGOs. NGOs in Georgia, in Azerbaijan (for supplies under grants agreements), and in Armenia (for supplies under charitable humanitarian aid agreements), are eligible for a VAT rebate, the equivalent of a zero rate.

The most common approach taken in the region, however, is not to exempt any particular type of organization, but instead to exempt transactions in certain goods and services. The VAT laws in each of the countries in this category contain a list of the types of goods and services that are exempt, and the list varies from country to country. For example, in Ukraine, charitable aid or free of charge transfers of goods and services to NPOs listed in the Registry are exempt from VAT, as are other transactions listed in the law.

2.5 Exemptions from Other Taxes

The most significant taxes for NGOs following VAT and income (profits) tax are the real estate tax and payroll taxes.

All countries in the Newly Independent States region exempt at least some NGOs from taxes on real estate, including land and buildings.[142] Usually, NGOs are exempt from real estate taxes to the extent that property is used to advance the organization's statutory purposes and is not used for unrelated business.

In some countries (for example, Armenia, Azerbaijan, and Georgia), NGOs enjoy a reduced rate on payroll taxes.

2.6 Availability of Tax Benefits to Donors for Contributions to NGOs

Most countries in the region grant at least some benefits, generally in the form of a tax deduction, to donors for contributions that they make to particular NGOs. Benefits may be available to both business and individual donors.[143] The average taxable profit for legal entities (or personal income for natural persons) can be reduced anywhere between 1-7 percent of profit, if donations are made to qualified NGOs (for example, in Ukraine, Kyrgyzstan, Moldova, Armenia, Uzbekistan, and Tajikistan).

However, several countries do not provide for tax deductions for some or all donors. For example, there are no tax benefits for either corporate or individual donors in Georgia or Belarus. No deductions are provided for natural persons who support NGOs in Kazakhstan and Turkmenistan.

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[142] The laws pertaining to value added, property, land, and other taxes are summarized in Section III (3) and (4)..

[143] The laws pertaining to the availability of tax benefits for donations by individuals and legal entities are summarized in Section III (2).

Appendix F Income from Business Activities
Employing a "Commerciality" Test for the Income or Profits Tax

Introduction. Most countries in the world use a "relatedness" test for determining whether a not-for-profit organization (NPO) is subject to income or profits tax on net income from business or commercial activities. Under a typical "relatedness" test, such as that used in the United States, the inquiry focuses on the issue of whether the income-producing activity "has a causal relationship" to the organization's not-for-profit purposes." (See Treas. Reg. § 1.513-1(d)(1)). For example, suppose that a museum charges an entrance fee – that sort of charge is clearly related to the not-for-profit purpose of the museum, which is to make cultural services available to the general public. Charging money for admission helps the museum defray its costs of operations, and it is a typical means of cost recovery for cultural institutions.

But what if the museum seeks to defray its operational costs by opening a gift shop[144] that sells the same type of "cultural" objects as are sold in for-profit gift shops?[145] Clearly this activity is only partly related to the museum's not-for-profit purpose, and the inquiry into whether it is sufficiently related to that purpose requires an analysis of whether it "contributes importantly to the accomplishment" of that purpose. (See Treas. Reg. § 1.513-1(d)(2)). According to the regulations in the United States, applying this test requires looking at "all the facts and circumstances," and there have been many rulings and litigated cases that deal with the finer points associated with making the distinction between related and unrelated activities. Simply contributing to the activity by raising money for it is not enough for the business to qualify as being "related."

Another way to deal with the taxability of net income from the performance of business/commercial activities by NPOs is to impose what is known as a "commerciality" test. Such a test looks to certain sub-tests, such as

- the degree to which the NPO competes with commercial entities; and
- the degree to which the NPO engages in behavior that is more appropriate for business entities, such as advertising, charging high prices, accumulating profits, etc.,

[144] In case readers may be tempted to treat this example lightly, it is informative to go to the website of the gift shop of the Metropolitan Museum of Art, located in New York City. The shop – called the Met Store – has 19 locations in the United States and 13 outside the United States. Many of the stores are in upscale shopping malls or in the shopping areas of major airports. The Met Store introduces itself as follows: "The Metropolitan Museum of Art has been engaged in the sale of art reproductions and publications since its founding in 1870. Your purchase supports the educational mission of the Museum by widening public awareness of art and contributing to basic operating expenses." See http://www.metmuseum.org/store/st_Categories.asp?shopperID=&FromPage=catbrowsestore

[145] It is also instructive for this discussion to note that there is a "Museum Store Association," which describes itself as an international "nonprofit organization…dedicated to the general welfare of the museum store industry. The association provides members with the education and resources they need to succeed in the challenging world of nonprofit retail." See http://www.museumdistrict.com/.

for the purpose of determining the commerciality of the income-producing activities of the NPO. Two countries, France and South Africa, have in recent years adopted versions of a "commerciality" test, applying these criteria; they are discussed in this memorandum.

A third criterion of "commerciality" used in France differs importantly from the tests used by both countries. The French rule requires an inquiry into whether the members of the board of directors of the NPO have a financial interest in the NPO (e.g., by having share ownership or by being paid a significant salary). If the directors do have such a "financial interest" in the NPO, it automatically does not qualify for tax exempt status.

The "financial interest" test used in France is not completely relevant in most countries because NPOs are generally subject to the non-distribution constraint and directors are not permitted to have ownership interests in NPOs. The explicitness of the French rule is helpful, however, for three reasons

- it reinforces the principle of "voluntariness" by requiring that NPO directors who are not employees be paid only modest sums for their service as directors;
- it ensures a degree of compliance with conflict of interest rules that prohibit interested directors from engaging in self-serving transactions with the NPO; and
- it ensures that governance and oversight of an NPO and its finances is carried out by disinterested directors.

The "financial interest" test is discussed in more detail in the section of the memorandum that deals with France.

I. South Africa

In 2000 the tax laws applicable to NPOs in South Africa were amended to deal, among other things, with the taxation of business activities, known as "trading" activities. Subsequent amendments in 2001 and 2003 have changed some of the rules, but not appreciably. Under the new framework, the law has been clarified and public benefit organizations (PBOs) approved for tax exemption are allowed to trade only within the parameters of the relevant provisions, as described here. These rules combine "relatedness" with "commerciality." Thus, they look first to whether the activity in question is closely related to the organization's not-for-profit activities. The rules for PBOs are as follows:

1. A *de minimis* rule provides that gross income from a business undertaking or trading activity must not exceed the greater of 15% of the gross receipts of the organization, or R25 000.

2. If the *de minimis* amount is exceeded, the following "tests" will apply to determine taxability of net income from the undertaking or activity.

A. The undertaking or activity must

(a) be integral and directly related to the sole not-for-profit purpose of the PBO; and

(b) be carried out or conducted on a basis substantially the whole of which is directed towards the recovery of cost and which would not result in unfair competition in relation to taxable entities; and

B. If the undertaking or activity, is not integral and directly related to the sole purpose of the PBO, it must

(a) be of an occasional nature; and

(b) be undertaken substantially with voluntary assistance (i.e., assistance without compensation).

C. Alternatively, the undertaking or activity may approved by the Minister by notice in the Gazette. In making such a determination the Minister should consider the following:

(a) the scope and benevolent nature of the undertaking or activity;

(b) the direct connection and interrelationship of the undertaking or activity with the sole purpose of the PBO;

(c) the profitability of the undertaking or activity; and

(d) the level of economic distortion that may be caused by the tax exempt status of the PBO carrying out the undertaking or activity.

Going back to the museum gift shop example and applying these tests, it is clear how difficult it may be to determine whether the museum should be taxable on the net income from gift shop operations. Assuming the *de minimis* test is not met, the first question is the same as the one used in the U.S. – are the operations related to the museum's not-for-profit purposes? If they are, then they must be conducted principally for the purpose of cost recovery AND it must not be in competition with operations of commercial entities. Meeting these requirements would ordinarily be difficult if the museum wanted to use the gift shop to obtain revenues to support its operations. Presumably some for-profit gift shops would claim that there is competition between the museum shop and their operations.

If the gift shop operations are determined to not be related to the NPO's purpose, then the second prong of the test would come into play. One can imagine a gift shop that is staffed only my museum volunteers and operates only on weekends, but such a shop would not contribute much to the revenues of the museum. Presumably the operations of many museum gift shops are not occasional and the staff who operate the shop are paid, which would mean that the gift shop could not meet the second test.

This would mean that the final "alternative" test would have to come into play, and "all the facts and circumstances" would need to be looked at. The Minister would be required to issue a ruling that the activities of the museum in operating the gift shop do not cause "economic distortion," which would presumably necessitate an inquiry into how many museum gift shops there are, whether they are competitive in price with for-profit gift shops, etc.

II. France[146]

In the late 1990's the French Ministry of Finance engaged in some serious rethinking of the way income from economic activities of NPOs should be taxed. The Ministry of Finance issued two fiscal instructions and explanatory documents in 1998 and 1999. The measures introduced by the Ministry were the result of a report ("Clarification of the tax treatment of NPOs") prepared by Mr. Goulard, counsel of the Conseil d'Etat, for the Prime Minister on March 10, 1998. The rules are described in the following discussion.

1. General Principles

The instructions confirm that the "exemption of NPOs from commercial taxes remains a general principle, and their liability the exception."[147] However, in order to guarantee the principle of equality before tax and to avoid the distortion caused by unfair competition, NPOs engaging in business activities are liable to pay commercial taxes *i.e.*, VAT, professional tax, and company tax.

2. Determination of the tax treatment of an NPO for purposes of company tax[148]

A three-step approach, described in the chart below,[149] aids in determining whether an NPO is liable for the payment of commercial taxes.

STEP 1

Does the management have a financial interest in the NPO?

No → Go to step 2

Yes → The NPO is liable for commercial taxes

STEP 2

Does the NPO compete with the business sector?

No → The NPO is exempt from commercial taxes

Yes → Go to step 3

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146 This section of the memo is based on an article written by Caroline L. Newman and published in the International Journal for Not-for-Profit Law.

147 Press communiqué of the Prime minister of September 15, 1998.

148 The rules for VAT and business tax are omitted.

149 Section 1 of the Fiscal instruction of September 15, 1998.

STEP 3

Does the NPO conduct its activities along similar lines to the business sector?

No

The NPO is exempt from commercial taxes

Yes

The NPO is liable for commercial taxes

The following discussion explains each of these steps.

2.1 Does the management have a financial interest in the NPO?

The management does not have a financial interest in the NPO when:

- The management and administration of the NPO are carried out on a voluntary basis.
- Profits are not distributed either directly or indirectly, but used for the statutory purposes of the NPO.
- In the case of dissolution, the assets of the NPO are to be transferred to another NPO and must not be distributed among members.

Since the last two points are self-explanatory, the only issue is when the management of the NPO is considered to be on a "voluntary basis."

Prior to the ministerial instruction issued in 1999, it was required that members of the board of directors not be remunerated at all.[150] However, it is now accepted that they may receive up to 75% of the minimum wage (SMIC)[151] as compensation for work performed for the NPO, for in-kind contributions, bonuses, and the reimbursement of unverified expenses.[152] The payment of rent at market rate for property used by the NPO and owned by a director or the payment of a

[150] « Organismes sans but lucratif, critères d'appréciation de la non-lucrativité, nouvelles règles », Edition Francis Lefèvre, FR 46-98, p. 7.

[151] SMIC (Salaire Minimum Interprofessionnel de Croissance) is the minimum monthly salary an employee should receive. The SMIC is established by the government.

[152] Undated document by the tax authorities addressed to the Interministerial Delegation to Social Innovation and Social Economy published in Edition Francis Lefèvre, FR 24-99, p. 3.

reasonable salary to a relative of a director who is employed in the NPO are not to be considered as grounds for disqualification of the NPO.[153]

This requirement is to be applied to each director on an annual basis. However, if a person is a director of several NPOs, which *are linked by their purpose, activities, and common directors,* the total remuneration of the director from all the related NPOs should not be greater than 75% of the minimum wage (SMIC).[154] It is accepted that a director may be an employee of the NPO and therefore receive a salary, but in this case, it is important that s/he be subject to the supervision of the governing body. Otherwise, if s/he were a *de facto* director and received a salary that was greater than 75% of the minimum wage, the NPO would be liable for payment of commercial taxes.[155]

Finally, the 1999 instruction clarified the issue of remuneration of employees serving on the board of directors of the organization as employee representatives. Their remuneration is not limited to 75% of the minimum wage, but they should not comprise more than one-fourth of the board of directors.

It is fairly unlikely that the museum operating a gift shop in our example will need to be concerned about violating the financial interest rules. Nonetheless they are important for smaller NPOs that provide other community services, such as health clinics that are managed by the medical staff who might also serve as board members, etc. It is clear that care must be taken to meet the requirement of voluntariness imposed by this test.

2.2 Does the NPO compete with the business sector?

Only activities (including secondary activities) that are identical to activities carried out by a business are to be taken into consideration in ascertaining whether an NPO violates this test. There is competition only when a particular need can be satisfied either by a business or an NPO in a given geographic area. It is further possible to evaluate whether the activity carried out by the NPO can effectively take clients away from the business entity and reduce its income.[156]

In applying this test to the museum gift shop, we can see that competition is the most significant factor. As with South Africa, the major issue therefore is the extent to which for-profit gift shops sell similar items to those sold in the museum shop. If they do not, then the museum shop can satisfy this test. But it is unlikely to be able to do so, since many of the items will be similar to items sold in commercial shops. Of course the museum could hold the intellectual property interests to the items in its collections and not license them to for-profit distributors, but similarity would seem to be the relevant criterion, not duplication of the items available.

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[153] Ministry of Economy and Finance, *Nouveau régime fiscal des NPOs*, Coll. Guide pratiques, La Documentation Française, Paris, 1999, p. 21.

[154] Undated document by the tax authorities addressed to the Interministerial Delegation to Social Innovation and Social Economy, *op. cit.* p. 3.

[155] *Nouveau régime fiscal des NPOs, op. cit.* p. 21.

[156] *Nouveau régime fiscal des NPOs, op. cit.* p. 23.

2.3 Does the NPO conduct its activities along lines similar to the business sector?

The methodology used in the third test to determine whether an NPO is exempt from commercial taxes requires an evaluation of the product, the public targeted, the price applied, and the publicity given to the product. The importance of these criteria, also called the "rule of the 4Ps", is to be applied in descending order. The product and the public are the key elements in determining the social utility of the activity.

2.3.1. The product

"An activity satisfying a need which is not satisfied or is poorly satisfied by the market" is of social utility. When an "*agrément*"[157] (accreditation) cannot be granted to a business entity, and so is granted to an NPO by the State,[158] the activity undertaken by the NPO is recognized as being of social utility.

2.3.2. The public

The term "public" is understood to encompass the persons who purchase goods or services from an NPO.[159] The activity is considered of social utility when the grant of specific advantages to the public is justified or the economic and social situation of the public justifies it.

2.3.3. The price

The price established for the provision of a good or service must be:

- Significantly lower than the market price (commercial taxes paid by business entities must be subtracted in order to compare the prices);[160]
- Sanctioned by public authorities; or
- Variable, depending on the situation of the public.

2.3.4. Publicity

Finally, it is necessary to evaluate how the organization manages its marketing campaigns. For that purpose, it is necessary to establish whether the NPO carries out informative marketing, which is acceptable, or commercial marketing, which is not.

Applying these tests to the museum gift shop, we can see that it might easily qualify for exemption if the items sold in the shop are not available in for-profit gift shops and if they are sold at below-market prices. On the other hand, to the extent the shop sells items that are available in for-profit gift shops or are similar to such items, it would not appear to be providing

[157] An "*agrément*" is granted by the Ministry relevant to the activity the organization is carrying out. It can be granted for licensing purposes, when a contract is established between the State and a legal entity. Some "*agréments*" are specific and can be only granted to NPOs such as to consumers organizations, sports organizations, popular education organizations, environment organizations...

[158] *Nouveau régime fiscal des NPOs, op. cit.* p. 25.

[159] Undated document by the tax authorities addressed to the Interministerial Delegation to Social Innovation and Social Economy, *op. cit.* p. 5.

[160] *Ibid.*

something that is of "social utility." In addition, it is not absolutely clear that the public needs the museum shop to provide it with the goods sold there, though presumably items such as reproductions of the art in the museum's collection might be available nowhere else. And, since the shop would be operated to make money for the museum, it would presumably be charging prices that would allow for more than cost recovery. The factor of advertising would also need to be discussed – it is not clear from the instruction to what extent advertising is allowed, but at least a little seems to be permitted. Thus, depending on the structure of the shop, what it sells, and how much it charges, there might need to be a special ruling with regard to the taxability of the revenues from its sales. Nevertheless, what this analysis makes clear is that the French rules give quite a bit of guidance as to how an NPO must structure its activities so as to avoid paying taxes on the net income or profits from business or commercial activities.

3. Accounting for commercial activities of NPOs

3.1 Division of activities into two classes: *"sectorisation"*

For purposes of the VAT, the "*sectorisation*" (division of activities into two classes, one for-profit and one not-for-profit) of activities was already a requirement. Now this system can be adopted by an NPO in order to escape company tax and professional tax on those activities that qualify as not-for-profit. The not-for-profit activities must remain dominant, and the accounting standards adopted should allow for the evaluation of each class of activity. The organization will achieve the "*sectorisation*" of its activity in adopting accounting standards that will allow the use of separate accounts for the activities qualifying as commercial and those qualifying as not-for-profit according to the "rule of 4Ps". Other parameters more difficult to account for, such as volunteers' time, will be taken into consideration. The assets of the organization must be allocated either to the commercial sector, the not-for-profit sector, or both.[161] In addition, donations allocated to the "not-for-profit sector" of the NPO will be tax deductible for the donor.

3.2. Creation of subsidiaries- *"filialisation"*

The active or passive (i.e., as a shareholder) participation of an NPO in a business entity can be of interest when the NPO carries out significant taxable activities. Indeed, transferring the commercial activities into a subsidiary prevents the NPO from losing its exemption from commercial taxes. However, if the activities of the NPO are carried out for the benefit of the subsidiary created (e.g., helping the subsidiary reduce its expenses, increase its profits, obtain more customers, improve its management, etc.)[162] the NPO may lose its tax exempt status.

The application of these rules to the museum gift shop suggests that proper accounting might require the shop to be treated separately from the other activities of the museum if it were determined to fail the "4 P's" tests of the 1999 instruction.

Conclusion. As this discussion shows, the application of a commerciality test may well provide a clearer path for making a determination about the taxability of income or profits from the business or commercial activities of an NPO. The more clearly articulated rule used in France is

[161] *Nouveau régime fiscal des NPOs, op. cit.* p. 32.

[162] *Nouveau régime fiscal des NPOs, op. cit.* p. 27.

actually easier to apply than the rule adopted in South Africa in large part because it is more precise. It gives both the government and the NPOs clarity as to what they should do in terms of structuring their income-producing activities.

Appendix G Deductions, Credits, and Reclaims

Deductions

TAXABLE INCOME	TAX RATE	TAX	GOV'T LOSES	CHARITY RECEIVES
100,000	40%	40,000		-0-
5,000 ➔ **charity**				
95,000	40%	38,000	2,000 (5%)	5,000
50,000	20%	10,000		-0-
5,000 ➔ **charity**				
45,000	20%	9,000	1,000 (10%)	5,000
25,000	10%	2,500		-0-
5,000 ➔ **charity**				
20,000	10%	2,000	500 (20%)	5,000

Credit

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

5,000 x 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 "reclaims" 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 "float" on taxes paid on contribution between the time received and the time the reclaim amount is paid.

Appendix H Model Provisions for Laws Affecting Public Benefit Organizations [*]

LAW ON PUBLIC BENEFIT ORGANIZATIONS

Preamble

In order to increase the role of Public Benefit Organizations (PBOs) in society, to promote their public benefit activities, to foster transparency and accountability, and to provide guidance to the government for using public benefit organizations in procurement of services for the benefit of the general public, the [*Parliament of Country*] enacts the following:

While some countries have a tradition of preambles, others do not. Even where no such tradition exists, however, a law that regulates a completely new area, or one that has not been regulated for decades, may well utilize a preamble in order to introduce the subject matter and the general principles, which can then be applied in interpreting the law.

The above preamble is based in part on the Hungarian law on PBOs (1997). While it is appropriate to include language in a preamble to a PBO law that encourages partnerships between the government and PBOs, it would not generally be appropriate to mandate by law that governments form partnerships with PBOs.

CHAPTER I GENERAL DEFINTIONS

Article 1: Public Benefit Activity

A Public Benefit Activity is any lawful activity that supports or promotes public benefit by supporting or promoting one or more of the following:

(a) Amateur athletics,

(b) Arts,

(c) Assistance to, or protection of physically or mentally handicapped people,

(d) Assistance to refugees,

(e) Charity,

(f) Civil or human rights,

(g) Consumer protection,

[*] This document has been developed by a group of experts in Central and Eastern Europe convened by the International Center for Not-for-Profit Law. It may also be relevant to countries in other regions of the world.

(h) Culture,

(i) Democracy,

(j) Ecology or the protection of environment,

(k) Education, training, and enlightenment,

(l) Elimination of discrimination based on race, ethnicity, religion, or any other legally proscribed form of discrimination,

(m) Elimination of poverty,

(n) Health or physical well-being,

(o) Historical preservation,

(p) Humanitarian or disaster relief,

(q) Medical care,

(r) Protection of children, youth, and disadvantaged individuals,

(s) Protection or care of injured or vulnerable animals,

(t) Relieving the burdens of government,

(u) Religion,

(v) Science,

(w) Social cohesion,

(x) Social or economic development,

(y) Social welfare,

(z) Any other activity that is determined by the Public Benefit Commission to support or promote public benefit.

The above list contains virtually all of the Public Benefit Activities recognized in one or more countries in Central and Eastern Europe, but no list can be comprehensive. The list may be too extensive for any particular country. What is most needed is that the list be interpreted and applied to promote activities that are beneficial to the public. Any list of Public Benefit Activities, of course, should reflect the needs, values, and traditions of the country in question. Further, no list of Public Benefit Activities should be closed, for the needs and values of any society change and evolve. See Art. 1(z). Finally, it is important to note that indicators of whether an organization will or will not qualify for Public Benefit Organization (PBO) status are provided by Art. 2.4 and 2.5.

Article 2: Public Benefit Organization

2.1 A Public Benefit Organization (PBO) is any Not-For-Profit Organization (NPO) that is:

(a) registered under [*relevant laws*];

(b) organized and operated principally to engage in Public Benefit Activities, as defined in Art. 1; and

(c) certified as such by the Public Benefits Commission.

The Model Provisions presume that NPOs are defined in and registered under other laws, and that those other laws include a prohibition on the distribution of profits. Most typically, NPOs will be either foundations or associations. It is possible, though, for countries to define other types of persons as NPOs (e.g., institutes, not-for-profit corporations). There is no need to exclude any particular kind of NPO from the possibility of qualifying as a PBO.

An organization is "organized" principally for public benefit if the purposes and activities permitted by its governing documents limit it to engaging principally in Public Benefit Activities. An organization is "operated" principally for public benefit if its actual activities are principally Public Benefit Activities. "Principally" may mean more than 50% or virtually all, depending on the context and the country. There are different ways of measuring whether the "principally" test, as used in this article, has been satisfied (e.g., portion of expenditures, portion of staff time, portion of facilities, etc.). The exact definition and method of measurement could be specified in a country's law, or it could be left to the Public Benefit Commission to define. Note, that defining and interpreting terms such as this argues strongly for a specialized commission to oversee the PBO sector (as opposed to other possibilities, discussed in reference to Art. 3 below).

2.2 Determination whether an NPO is organized and operated principally to engage in Public Benefit Activities will be based on the NPO's certification application and activities, if any.

2.3 Qualification for public benefit status will be based on whether the NPO's application, subsequent reports, and other information, taken as a whole and considering all facts and circumstances, indicate that the NPO is organized and operated principally to engage in Public Benefit Activities.

2.4 Factors to be taken into account in determining that an NPO is organized and operated to engage principally in Public Benefit Activities generally include:

(a) That the NPO provides significant benefits

(i) to the public-at-large, or

(ii) to a targeted class of beneficiaries, where

(A) the class is disadvantaged relative to the population as a whole, or

(B) there is a significant value to the community in providing special benefits to the targeted class.

Note that this factor constitutes a significant limitation on what constitutes a PBO. This factor means that it is not sufficient for an organization to engage in a Public Benefit Activity as listed in Article 1. It should also provide significant benefits, either to the public at large or to a targeted group under the conditions specified above. Thus by combining this article with Article 1 (x), for example, the Public Benefit Commission should determine that an organization that promotes economic development only in a prosperous area would not qualify as a PBO. One that promoted economic development in a disadvantaged region of a country, however, or even *in a whole country if the entire population can be deemed "disadvantaged," would be eligible for PBO status.*

(b) That the NPO provides significant goods and services at or below cost;

(c) All other factors indicating that the NPO is organized and operated principally to engage in Public Benefit Activities.

2.5 Factors to be taken into account in determining that an NPO is not organized and operated to engage principally in Public Benefit Activities generally include:

(a) That the NPO targets a closed or otherwise limited class of beneficiaries, particularly one that includes persons affiliated in some way with the organization or its staff;

(b) That the nature and extent of the NPO's economic activities indicate that the NPO is not merely advancing its not-for-profit purposes but is instead organized and operated principally for a commercial purpose;

The purpose of this factor is to ensure that what is essentially a commercial business not be afforded the protection of PBO status. If the economic activities advance the public benefit purposes of the NPO, however, they should not be deemed a negative factor. See Article 13 and the accompanying note.

(c) That the NPO regularly engages in the sale of goods or services at a price above cost; and

Selling goods and services in substantial amounts at prices that exceed cost is often an indicator that an NPO is in reality a commercial business.

(d) That the NPO provides unreasonable compensation or other special benefits to its employees or other persons affiliated with the organization.

The terms "reasonable" or "unreasonable," or their functional equivalent, are often defined in other laws. For example, in a specific country "unreasonable compensation" might mean "compensation that is more than 30% above the average compensation paid in that country to people who have similar jobs."

Chapter II Public Benefit Commission

Article 3: Establishment and Composition

3.1 A Public Benefit Commission (Commission) is established in this law as an independent administrative body composed of representatives of the government, the PBO community, and the public.

The Model Provisions establishes a Public Benefit Commission. The Commission acts as the certification, oversight, and sanctioning authority. The Commission should receive an annual budget appropriation necessary for the fulfillment of its duties. **.** *A key benefit of unifying these* *various authorities 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.*

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

The administrative law of the country will, of course, regulate the establishment and operations of the Commission. Many essential features of the Commission are not addressed in the Model Provisions because different solutions will be appropriate for different countries. For example, a specific Commission size needs to be stipulated. In general, the Commission 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 Commission, terms of service of Commissioners, and the process through which they are selected are not specified. Again, there are many possible solutions; the one most appropriate for a particular country should be selected and included in that country's PBO law.

An interesting approach to the Commission size and composition 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 there might be no parliamentary representation on the Commission, but instead 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.

The length of terms for the Commissioners serving on the Commission should generally be between two (2) and six (6) years. The term should be long enough to assure experience on the Commission, 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.

Article 4: Certification Authority

4.1 As the certifying authority, the Commission shall:

(a) certify PBOs;

(b) decertify PBOs in accordance with Article 10;

(c) maintain certification files of PBOs as required in Arts. 4.2 - 4.4;

(d) issue forms, instructions, and model documents; and

(e) provide advice and training to PBOs.

4.2 PBO certification files shall be maintained at a central registry. The files shall contain the application documents filed by each certified PBO and a register of all PBOs that are certified.

4.3 The register and the certification file of each certified and decertified PBO shall be open to public inspection during ordinary business hours. Any person may request, in person or by mail, a copy of any entry in the register or any documents in a certification file. No more than a reasonable charge may be made for such copies. The requested copies, or a written decision explaining the reasons for the denial of the request, shall be furnished within thirty (30) days of request. All files may also be made available through the Internet.

4.4 Any organization that has been decertified shall be removed from the register, but the file, including the decision on decertification shall be retained and made available to the public.

Article 5: Oversight authority

5.1 As the oversight authority, the Commission shall:

(a) issue regulations and interpretations;

(b) monitor and enforce compliance with this law and Commission regulations;

(c) receive and review reports;

(d) subject to the limitations of Art. 5.2, investigate possible violations of this law and regulations by a PBO by examining its books, records, premises, and activities during normal business hours;

(e) provide PBOs with appropriate support and training; and

(f) serve as a liason between PBOs, the government, and parliament on PBO issues.

5.2 A PBO that is being investigated in accordance with Art. 5.1(d) may refuse access to its books, records, or premises if it believes that the investigation is improper or is a violation of its rights or the rights of any other person. In order to proceed with the investigation, the Commission must then seek enforcement from a court of competent jurisdiction, which shall have the power to impose sanctions for abusive investigations or frivolous refusals to cooperate.

This provision, of course, must be applied in accordence with the criminal and administrative law of the country.

Article 6: Sanctioning authority

After a written notice of non-compliance has been given and an adequate opportunity to correct any defect has been provided, the Commission, as the sanctioning authority, may:

(a) sanction a PBO with a fine of up to [*a stipulated amount of money*] for violation of, or non-compliance with, any provision of this law;

(b) sanction a PBO with a fine of up to [*a stipulated amount of money*] for violation of, or non-compliance with, a valid Commission regulation; or

(c) suspend or decertify a PBO in accordance with Art. 10.

Chapter III PBO Certification

Article 7: Documents to be Filed

Any organization seeking status as a PBO shall file the following documents with the Commission:

(a) a copy of the organization's founding act and statutes;

(b) a copy of all documents filed in connection with the registration of the organization as an NPO; and

(c) a completed application form stating

  (i) the public benefit purposes, for which the PBO is organized and operated;

  (ii) all of the principal activities that the PBO will engage in; and

  (iii) any economic or political activities that the PBO may engage in.

Article 8: Certification and Refusal to Certify

8.1 The Commission shall issue to a PBO a written PBO certification or a written decision denying certification within sixty (60) days of receiving an application for certification, unless the Commission properly requests, in writing, further information or clarification.

8.2 Upon receipt of further information or the requested clarification, the Commission shall issue either written PBO certification or a written decision denying certification within:

(a) the number of days remaining in the original sixty (60) day time period for issuing a decision; or

(b) ten (10) days of receipt of the further information or requested clarification, whichever is greater.

8.3 An organization shall acquire PBO status upon certification.

8.4 If certification is denied, the Commission shall issue, together with the written denial, a detailed written explanation of the grounds for denial of certification.

8.5 Certification may be refused only for any of the following reasons:

(a) The certification application is materially incomplete;

(b) The applicant organization does not meet the qualification requirements of Art. 2; or

(c) The applicant organization has committed a serious violation or repeated violations of:

(i) this law;

(ii) other laws; or

(iii) regulations.

Article 9: Default Certification

If the Commission fails to make a decision on the certification of an organization as a PBO prior to the expiration of the time limit(s) provided in Art. 8, the organization shall be automatically entitled to certification as a PBO. In the event of automatic certification, the Commission shall issue the customary written PBO certification, and the organization shall be entered into the registry in the ordinary manner.

Article 10: Decertification

10.1 A PBO may choose to decertify at any time by filing with the Commission an application declaring that, pursuant to its rules of governance, the Governing Body has, by resolution, decided to decertify.

10.2 Subject to Arts 6 and 10.3, the Commission may suspend or revoke PBO certification only if there is substantial and credible evidence that the PBO has committed a serious violation or repeated violations of:

(a) this law;

(b) other laws; or

(c) regulations.

10.3 The Commission may suspend or revoke PBO certification only after it has given reasonable notice to the PBO and given it an opportunity to correct the defect responsible for the Commission's decision to suspend or revoke PBO certification.

10.4 Decertification occurs pursuant to Art. 10.1 when a PBO files its intent to decertify, or, pursuant to Art. 10.2, when the Commission issues a written notice of decertification to the organization.

10.5 Decertification terminates all PBO benefits but does not terminate any obligations, including those with respect to monies or assets obtained while the organization was a certified PBO, nor does it terminate reporting requirements covering any such monies or assets or any period of time during which it was a certified PBO.

Thus, a PBO cannot escape the responsibilities imposed by this law by decertifying. Note that decertification in no way affects an organization's status as an NPO, only its status as a PBO.

Chapter IV PBO Governence

Article 11: Governing Body

11.1 A PBO shall be governed by a Governing Body of at least five (5) members, three (3) of whom are not related to each other. The Governing Body of a PBO shall have ultimate responsibility for its policies and financial affairs. Except as otherwise provided by the Commission, incompetent individuals, those who have not yet attained the age of sixteen (16), and persons who have been convicted of a felony within the ten (10) years prior to their proposed beginning date of service, are not eligible to serve on the Governing Body.

11.2 The Governing Body shall meet at least once a year to fulfill its obligations, including reviewing and approving the assets, liabilities, income, expenditures, and programs of the PBO for the past year and the anticipated assets, liabilities, income, expenditures, and programs for the upcoming year.

11.3 The Governing Body of a PBO shall not delegate:

(a) its duties under this Article; the election of its officers;

the process by which its Founding Instrument or Statute can be amended; or

(c) decisions to merge, split up, dissolve, or decertify the PBO.

Article 12: Supervisory Body or Audit Committee

12.1 A PBO, the revenues of which exceeds [*a stipulated amount of money*] for the most recently completed fiscal year, shall also have a Supervisory Body or an Audit Committee, no member of which shall be an officer or employee of the PBO. The Supervisory Body or Audit Committee shall have access to all books, records, and information concerning the activities of the organization, and shall be responsible for determining at least annually whether the organization is in compliance with the requirements of law and of the organization's founding act, statutes, and the resolutions of its Governing Body.

Note that the creation of a Supervisory Body or an Audit Committee is required only of larger organizations, as an additional internal check on their activities and operations.

12.2 The Supervisory Body or Audit Committee shall report its findings at least annually to the Governing Body. If the Supervisory Body or Audit Committee discovers serious irregularities, which, after reasonable written notice, the Governing Body fails to correct or prevent, it shall report the irregularities to the proper governmental authority.

CHAPTER V PBO OPERATIONS

Article 13: Economic Activity

A PBO may engage in economic activities, but only so long as economic activities unrelated to Public Benefit Activities do not constitute the principal activities of the PBO.

It is permissible for a PBO to support its Public Benefit Activities with revenue earned from economic activities, that is, revenue generated by the sale of goods or services. Related economic activities – those that advance the public benefit purposes of the organization -- should be allowed, for often conducting economic activities is the most effective way to carry out public benefit activities. Some economic activities that are unrelated to a PBO's principal purpose may also be allowed, especially if any profits are used to support the public benefit activities of the organization. However, allowing unlimited economic activities unrelated to the principal purpose of the organization is inconsistent with PBO status and may lead to tax evasion or unfair competition between PBOs and the for-profit sector.

The Model Provisions allow a PBO to engage in any legal economic activities while ensuring that the organization does not conduct unrelated economic activities as its principal activity.

Article 14: Public Policy and Political Activities

14.1 A PBO may engage freely in research, education, publication, and advocacy with respect to any issue affecting the public interest, including criticism of the policies or activities of the state or any officer or organ thereof. It may also express its views on any issue or policy that is or may be debated or discussed in the course of a political campaign or election.

14.2 A PBO may not engage in fundraising or campaigning to support or oppose any political party or candidate for appointive or elective public office, nor may it propose or register candidates for elective public office.

A strong dedication to complete freedom of expression would argue for no limit whatsoever on political speech and advocacy by PBOs. The Model Provisions take the position that resources of PBOs should not be used to support specific political parties or candidates. One reason for this approach is to prevent evasion of laws governing political parties and elections. There should definitely be no prohibition or limitation, however on a PBO's right to publicly advocate in favor of or against any cause, to criticize the policies or actions of the government, or to provide information in support or opposition to particular solutions to social questions.

Article 15: Fundraising

Any person who engages in public fundraising on behalf of a PBO may be required by any person being solicited to demonstrate that the organization is a registered PBO and to give an accurate description of its purposes, the percentage of its income expended on overhead and fundraising activities, and that person's authority to engage in solicitation on behalf of the organization.

The purpose of this provision is to assure that members of the public who are asked to make a contribution to a PBO have available to them information relevant to deciding whether to contribute. The approach taken in Art. 15 avoids the cost, delay, and rent-seeking behavior that often characterizes a governmental licensing scheme.

Article 16: Books and Records

Each PBO shall maintain accurate and complete books and records of its financial activities in accordance with accepted accounting standards and shall adopt a reasonable record retention policy with respect to both its financial and non-financial books and records.

It would be appropriate for the Public Benefit Commission to promulgate record retention rules, accounting standards, forms, and instructions.

Article 17: Audit Requirement

A PBO, the revenues of which exceed [*a stipulated amount of money*] for the most recently completed fiscal year, shall be required to have an independent audit of its finances.

Chapter VI PBO Reporting

Article 18: General Reporting and Transparency Requirement

18.1 A PBO, the revenues of which exceed [*a stipulated amount of money*] for the most recently completed fiscal year, shall file activity and financial reports with the Commission and the appropriate fiscal authorities. The reports shall also be made available to the members of the public, upon request, for no more than a reasonable charge.

18.2 A PBO that is subject to the audit requirement of Art. 16 shall file a copy of the audit as part of its financial report.

In order to foster the growth of the PBO sector, it is important not to overburden small PBOs with cumbersome reporting requirements. Thus, the Model Provisions includes no external reporting requirements at all for very small PBOs and an independent audit report only for very large PBOs. Commission regulations will determine the form and content of the reports.

Chapter VII Miscellaneous Provisions

Article 19: Liquidation

19.1 In the event of a voluntary or involuntary liquidation of a legal person certified as a PBO, the Governing Body of the PBO shall submit a plan of liquidation to the Public Benefits Commission. The plan shall include appropriate provisions ensuring that any assets remaining after the discharge of all debts and liabilities be distributed to another PBO to be used for purposes similar to those of the liquidated PBO.

19.2 No distribution of assets can be made except pursuant to the plan of liquidation approved by the Commission.

Article 20: Effect on Other Laws

This law repeals [*cite laws to be repealed*].

Article 21: Effective Date and Transition Period

This law shall take effect on [*date*]. Organizations having a status under prior laws similar or equivalent to PBO status shall have one (1) year following the effective date to seek certification as a PBO under this law. Any such organization that fails to seek certification under this law, after specific notice to it and a reasonable opportunity to do so, shall cease to have PBO or any similar or equivalent status thirty (30) days after the expiration of the specific notice period, unless it has, by then, filed its PBO certification application.

Other Selected Provisions Needed for Effective PBO Regulation

LAW ON NOT-FOR-PROFIT ORGANIZATIONS (NPOs)

Refusal to Register

Registration may be refused by [*the registering body*] if the name prepared for the organization is identical to that of any registered organization, any other person or legal entity, or any public body, or is so similar that confusion would be created in the mind of the public in [Country].

Thus, without the permission of the holder of the name, an organization could not register as the Vaclav Havel, Coca Cola, or Ministry of Justice Foundation.

Failsafe Provisions When it is Impossible to Obtain a Quorum

1. In the case of an organization governed by its Members, if after proper notice, there is not a sufficient number of Members of the Organization at the scheduled Annual General Meeting of Members to constitute a quorum, a second notice shall be sent out for a meeting to be held at a reasonable time and place but no sooner that ten (10) days later. Whatever number of Members shall be present at the rescheduled meeting shall constitute a quorum for the conduct of all business for which no special quorum is required.
2. In the case of an organization governed by a Governing Body rather than all of its Members, if by reason of death, incapacity, resignation, or other good cause, it is impossible to obtain a quorum for a meeting of the Governing Body, the members who are present at a meeting scheduled at a reasonable time and place and after proper notice shall constitute a quorum for the purpose only of electing enough additional directors so that a quorum exists for the conduct of other business.

Duties and Liabilities of Officers, Governing Body Members, and Employees

1. Officers, Governing Body members, and employees of an NPO shall:
   a) execute their responsibilities to the organization with care, diligence, and prudence;
   b) exercise loyalty to the organization;
   c) maintain confidentiality of the organization's non-public information; and
   d) ensure that the organization obeys applicable law and abides by its statutes, rules, and resolutions.

2. No person who is a officer, Governing Body member, or employee of a PBO shall be personally liable for the debts, obligations, or liabilities of the PBO, but each shall be liable individually to the PBO or any affected third party for willful or grossly negligent performance or neglect of his or her duties.

Prohibition on Personal Benefit

The assets, earnings, and profits of an NPO shall be used to support the purposes of the NPO and they shall not be distributed, directly or indirectly, to any person. This section does not preclude reimbursement of reasonable expenses or payment of reasonable compensation to any person for work performed for the NPO.

Conflicts of Interest

1. A conflict of interest is any interest, purpose, or concern of a person that is or may be inconsistent with the interests, purposes, or concerns of an NPO.
2. If any person performing services for, or exercising any authority on behalf of an NPO, including any officer, Governing Body member, or employee of an NPO, has a conflict

of interest, that person shall disclose the nature and possible effects of that conflict of interest to the Governing Body of the NPO.

3. Except as provided in (2) above, a person with a conflict of interest shall not participate in the discussion or decision of any matter involving the NPO as to which he or she has a conflict of interest.

4. Any transaction between an NPO and an affiliated organization, or between an NPO and its officers, Governing Body members, or employees shall be prohibited unless the Governing Body determines after reasonable investigation that the transaction is in the best interest of, and fair and reasonable to, the organization and that the organization could not have obtained a more advantageous arrangement with reasonable effort under the circumstances.

LAW ON TAXATION

Income Tax

A PBO shall be exempt from taxation on all of its income.

Under this provision, income received by a PBO from fees, donations, grants, government contracts, or membership dues would not be subject to income taxation. In addition, the income from economic activities earned by a PBO will also be exempt from income taxation.

Customs Benefits

Goods, supplies, and equipment imported by a PBO and (i) consumed by it in connection with Public Benefit Activities, (ii) used by it for at least three (3) years for Public Benefit Activities, or (iii) distributed free of charge in connection with Public Benefit Activities, shall be exempt from customs duties.

Donor Benefits

1. Donations or contributions by an individual or a business entity to a PBO that engages exclusively in Public Benefit Activities, or which are restricted for use for Public Benefit Activities, shall be deductible from taxable income in the computation of income taxation in an amount of up to:

   (a) fifty (50) percent of taxable income for individuals; and

   (b) ten (10) percent of taxable income for business entities.

Some countries allow individuals to claim deductions for contributions to PBOs for up to 100% of their income; others permit deductions only up to a very small percentage of income. It is difficult for individuals to make large gifts, such as gifts to create an endowment or to provide a major facility for a PBO, unless the limit is fairly generous. Fifty percent is a middle-ground *position that will encourage donations to support public benefit activities. Few companies contribute more than ten percent of their profits to PBOs, so the suggested limit is adequate.*

2. The amount of any donor deduction shall be reduced by the value of any goods or services received by the donor as a result of his or her contribution.

ADMINISTRATIVE LAW

Appeals

Decisions of the Commission, including but not limited to refusal to certify an organization as a PBO, the imposition of a sanction, or decertification may be appealed to a court of competent jurisdiction, which shall be entitled to examine the factual and legal basis for the Commission's action or proposed action.

NOTE ON PUBLIC PROCUREMENT AND GRANTS

Organizations shall not be ineligible to participate in public procurement because of their status as PBOs. Some areas of procurement may be reserved exclusively for PBOs. Special PBO grant procedures may be instituted when the governmental purpose is uncertain or less capable of being defined precisely at the outset.