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SURVEY OF TAX LAWS

AFFECTING NON-GOVERNMENTAL ORGANIZATIONS IN CENTRAL AND EASTERN EUROPE

SECOND EDITION

International Center for Not-for-Profit Law

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Every effort has been made to ensure that the information in this paper is current. Nonetheless, the paper may not reflect changes in the laws that have occurred since the receipt of the survey responses.

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I. INTRODUCTION

This paper surveys current tax laws governing not-for-profit, non-governmental organizations ("NGOs") in sixteen jurisdictions in Central and Eastern Europe. These are: Albania, Bosnia & Herzegovina[1], Bulgaria, Croatia, the Czech Republic, Estonia, Kosovo[2], Hungary, Latvia, Lithuania, Macedonia, Poland, Romania, Serbia & Montenegro[3], Slovakia, and Slovenia. The paper 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. The survey questionnaire, a copy of which is attached as Exhibit A, inquires about the laws on income or profits taxes for NGOs; exemptions from such taxes available to NGOs; the treatment of income from business and investment activities; the application of, and exemption from, other taxes, such as real property, gift and inheritance, and value-added tax; and the availability of tax credits or deductions to individuals and businesses that make charitable contributions to NGOs or "engage in philanthropy." The relevant provisions of the laws of the sixteen jurisdictions are summarized in charts appended as Exhibits B – H. Summaries of the survey questionnaire responses are attached as Exhibit I.

The survey has two purposes. The first is informational; the survey compiles information regarding the tax laws applicable to NGOs as they currently exist. The second is analytical. This paper seeks to identify those areas in which reform of the tax laws in the region would help to bring those laws into conformity with international good practice, thereby improving the enabling environment for NGOs and enhancing their ability to sustain themselves financially.

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1 The Republic of Bosnia & Herzegovina is made up of two entities under the Dayton Agreement, the Federation of Bosnia & Herzegovina and the Republic of Srpska. This paper will refer to Bosnia & Herzegovina where the laws of the two entities are essentially the same. Where the laws diverge in their treatment of an issue, the laws of the Federation and of the Republic of Srpska will be discussed separately.

2 The Serbian province of Kosovo has since 1999 has been governed by the United Nations Interim Administration Mission in Kosovo ("UNMIK.") UNMIK may issue regulations in the performance of its duties. UNMIK Regulation 1999/1, §3. In 2001, UNMIK issued a regulation establishing a Constitutional Framework for Kosovo. UNMIK Regulation 2001/9. As a result, "Provisional Institutions of Self-Governance" including a Parliament and Ministries were established. Because Kosovo is separately governed, and because the laws regarding the establishment of NGOs as well as their taxation depart significantly from those in existence in Serbia & Montenegro, Kosovo will be treated separately for the purposes of this survey.

3 The recent enactment of the Constitutional Charter of Serbia & Montenegro marked the final step in the dissolution of the Federal Republic of Yugoslavia. The federation of the two republics envisaged by the 1992 FRY constitution has given way to a loose confederation whose precise authorities have yet to be defined. This paper will refer to Serbia & Montenegro where the laws of the two entities are in accord, and will discuss the laws of each entity separately only where the two differ in their treatment of a particular issue.

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Tax preferences are generally considered necessary to create a strong enabling environment for NGOs.[4] They do so by allowing NGOs to have a reduced tax burden through tax exemptions. In most countries with developed NGO sectors, the law provides for exemptions from income and profits taxes ordinarily imposed on legal entities to a broad range of not-for-profit organizations, including "public benefit" organizations as well as "mutual benefit" (or "member benefit") organizations.[5] A "public benefit" organization by definition benefits the public or some segment of it, while a "mutual benefit" organization benefits only its members. Public benefit organizations generally are regarded as entitled to greater tax benefits. For public benefit organizations, contributions, grants, and member dues are ordinarily free from profits tax, as is some income from economic and investment activities, at least under certain conditions. In addition, NGOs, and particularly public benefit NGOs, may receive exemptions from other taxes.

Tax systems also typically include incentives for philanthropy. Tax benefits to donors are ordinarily provided in the form of either a deduction or credit for the donor. Deductions reduce the amount of income subject to tax, and are the more common form of benefit granted. Credits reduce the amount of tax owed and are used less frequently.[6] The granting of tax benefits to donors is generally restricted to those who contribute to public benefit NGOs.

The survey reveals that most countries in the region have made progress towards modernizing their tax laws and creating an enabling fiscal environment for NGOs. Most of the countries, for example, have laws granting tax exemptions to certain NGOs for at least some sources of income. In addition, most have extended tax benefits, usually deductions, to individuals and businesses that donate to certain types of NGOs.

Moreover, several countries have developed innovative practices that can serve as models for the rest of the region, as well as for countries outside of Central and Eastern Europe:

4 For a more extensive discussion of international good practice in the granting of tax benefits, and the role of such benefits in improving the enabling environment for NGOs, see International Center for Not-for-Profit Law, "Tax Preferences for Nongovernmental Organizations" ICNL website, www.icnl.org (1999, 2000) [hereinafter "Tax Preferences"]; International Center for Not-for-Profit Law for the Open Society Institute, *Guidelines for Laws Affecting Civic Organizations* (New York, NY: 2003).

5 In the United States, for example, the Internal Revenue Code provides exemptions for 25 categories of organizations ranging from health, educational, scientific, charitable, and other traditional public benefit organizations to unions, trade associations, and other member benefit type organizations. See 26 U.S.C. §501(c).

6 In Central and Eastern Europe, only Hungary and Latvia provides for tax credits. In Hungary, the credit extends to for donations by individuals, while in Latvia, it is available for donations by businesses. A third form of tax incentive for giving is found in the United Kingdom. Under this system, the tax saved by the donor as a result of the gift is paid directly to the organization that receives the donation. For example, if the donor makes a donation of GBP 100, producing a tax saving of GBP 10, the GBP 10 is paid by the Treasury directly to the charity.

• Hungary enacted a law in 1996 that permits taxpayers to direct that 1 percent of their taxes be paid to NGOs designated by them (hereinafter referred to as a "tax designation law"). By providing a simple mechanism for directing tax funds to NGOs, the "1% Law" creates a significant pool of resources – in 2001, 14 million taxpayers made 1% designations worth $25 million USD – to support socially beneficial activities. In recent years, other countries have adopted this model: Slovakia has a 1% Law that went into effect January 1, 2002, Lithuania in 2002 enacted a law that permits a 2% designation, and Poland enacted a Law on Public Benefit Activities and Volunteerism in April 2003 that includes a "1%" provision.

• The Czech Republic has enacted legislation permitting the establishment of endowment funds and granting tax benefits to earnings on the "endowment" funds. The existing restrictions on investment and the administrative burdens connected with registering the endowment limit flexibility in the management of the funds. Nevertheless, the law creates the ground rules for the development of invested endowments as a means of financing NGO activities.

There are a number of areas, however, in which reform of the existing tax laws in the region is necessary in order to ensure the continuing financial sustainability of NGOs. These include:

• *Exempting from profit tax at least some income earned by NGOs from business activities.* Given low levels of indigenous philanthropy and reductions in foreign donations, inventives for NGOs to raise funds from ancillary business activities is essential for the sector's viability.

• *Improving tax incentives for philanthropy, and particularly for individual philanthropy.* These incentives not only encourage a much needed source of revenues for the sector, but by encouraging individual and business commitments to NGOs can also promote stronger ties between the NGO sector and the communities it serves.

• *Reforming VAT laws.* The countries on the verge of joining the EU have already undertaken reform of VAT laws; other countries contemplating accession must confront the need to harmonize their VAT laws with the EU's directive on VAT.

• *Providing tax incentives for investments.* Such incentives would encourage greater investment of assets by NGOs to earn income to support their activities.

• *Extending tax exemptions to mutual benefit as well as public benefit organizations.* This would promote associations which provide an outlet for a wide variety of citizen interests.

• *Providing appropriate transparency and accountability rules.* NGOs receiving tax benefits should be accountable for their use of such benefits; there is a need to develop rules that balance the needs of government and the public for accountability with sensitivity to the burdens such rules may place on NGOs.

This paper will first discuss the tax laws affecting NGOs in the countries of the

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region. It will then analyze those areas in which reform is most necessary if these countries are to provide an enabling fiscal environment for the NGO sector.

II. ANALYSIS OF EXISTING TAX LAWS AFFECTING NGOS IN CENTRAL AND EASTERN EUROPEAN COUNTRIES

Tax laws in fifteen of the sixteen jurisdictions studied in this survey all grant certain types of organizations the ability to seek exemption from the income or profits taxes imposed on legal entities. The sixteenth country, Estonia, has an income tax system in which legal entities, including NGOs, no longer pay tax on their profits.[7] Instead, they pay tax on certain categories of distributions that they make. The way in which NGOs are treated under this tax regime is dealt with separately at the end of this section.

The legal requirements for exemptions from income or profits taxes in the other fifteen jurisdictions address two categories of issues:

1. *The types of organizations permitted to seek tax exemptions.* In establishing the legal requirements for tax exempt status, some countries permit the exemption to be claimed by virtually all legal forms of organizations (i.e., foundations, associations, and other types of not-for-profit legal entities)[8] provided that they are duly registered and that they adhere to the nondistribution constraint.[9] Other countries limit the availability of the exemption to organizations that serve the public benefit. Several do not make exemptions available to any type of NGO, and allow only very limited exemptions to legal entities pursuing activities on behalf of the disabled.

2. *The sources of tax exempt income.* Most countries in the region treat income from grants, donations, fees and dues as tax exempt. Other sources of income, such as income from economic activities (sales of goods or services), and income from passive investments (*e.g.,* dividends, interest, rents), may be considered tax exempt only where they meet certain conditions.

In addition to income and profits taxes, countries impose a variety of other taxes on legal entities, such as real property tax and value added tax (VAT), among oth-

7 The law was enacted December 15, 1999, and became effective January 1, 2000.

8 The two most common organizational forms used to establish NGOs in the region are the foundation and the association, although several countries authorize other forms, including Albania (center), Hungary (public benefit company, civil society organization), the Czech Republic (fund, public benefit company), Slovakia (non-investment fund, nonprofit organization providing generally beneficial services), and Lithuania (public institution).

9 The nondistribution constraint prohibits an NGO from distributing its profits as such and requires that its assets, earnings, and profits be used to support the organization's purposes, and not to provide special benefits to its founders, directors, officers, employees and others associated with it. Thus, all profits must be retained to support the NGO's operations. This feature distinguishes NGOs from for-profit businesses.

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ers. Within Central and Eastern Europe, practices with respect to exemptions from these other taxes vary widely among the countries.

A summary of the tax laws pertaining to these issues is provided below.

A. INCOME OR PROFITS TAX EXEMPTIONS

1. Organizations Entitled to Seek Income or Profits Tax Exemptions

All countries in the region permit at least some types of NGOs to claim exemptions from income or profits taxes generally imposed upon legal entities for at least some types of income.[10]

Public benefit and mutual benefit organizations exempt. The majority of countries in the region permit many types of NGOs, both public benefit and mutual benefit, to claim profits or income tax exemptions for certain types of income. These countries are: Croatia, the Czech Republic, Hungary, Latvia, Lithuania, Romania, Serbia & Montenegro, and Slovakia, as well as the Federation of Bosnia & Herzegovina. These laws are in accord with international good practice, which encourages exemptions for associations which benefit only their members, such as clubs and societies, as well as for organizations that serve the public interest, such as traditional charities or social assistance organizations.

In some countries, the law reflects a rationale that NGOs, as non-business entities, are not proper subjects of taxation, at least with respect to certain types of income.[11] For example, in Slovakia, the law provides that foundations and associations are not established for a business purpose and as such are not subject to tax on income from grants and membership dues.[12] In Latvia, not-for-profit organizations and public organizations that do not carry out business activities are not subject to the business income tax.[13] In the Federation of Bosnia & Herzegovina, NGOs are not subject to corporate income tax. A similar rule frees all types of NGOs from profits tax in Lithuania.[14]

More frequently, the laws treat NGOs as taxable legal entities, but permit them to claim exemption from the corporate income or profits tax. In the Czech Republic, for example, the Corporate Income Tax law provides that all organizations

10 The laws of the countries surveyed regarding the types of organizations entitled to claim exemptions from profits tax are summarized in Exhibit B.

11 *See* Tax Preferences, *supra* note 4.

12 Act on Income Taxes, No. 366/1999.

13 The exemption also applies to private pension funds, which are NGOs in the broad sense of the term, but are not the subject of this paper.

14 In Lithuania, however, there is a trade off; certain types of organizations are not entitled to conduct directly any type of economic activity to earn income. See *infra* § II.A.2.

established to perform not-for-profit activities are entitled either to an exemption from, or reduction in, tax depending on the source of the income.[15] The law contains a long list of legal entities entitled to tax benefits, including citizens' associations, funds, foundations, public benefit corporations, churches and religious societies, and public higher educational institutions. These benefits are available provided that the revenues are used to advance the organization's statutory activities. In Croatia, religious communities, political parties, trade unions, chambers, associations, trusts, and foundations organized for charitable, humanitarian, scientific, cultural, or similar purposes, as well as other not-for-profit organizations and institutions not specifically named, are entitled to claim tax exemptions. Romania's law exempts a similarly broad list of organizations. In Serbia, corporate tax law does not explicitly address non-governmental organizations as income or profit tax exempt. Rather, it refers to "other legal entities," which the law exempts from tax. These primarily include associations, legacies, foundations, religious, and sports organizations.

In Hungary, the Corporate Income Tax law applies to the "business activities" of all legal entities, including public benefit organizations, "prominently" public benefit organizations,[16] public benefit corporations, foundations, public foundations, civil society organizations, churches, and others. Business income below an established threshold is exempt from tax.[17] Certain types of activities by foundations, public foundations, civil society organizations, and public chambers are not defined as "business activities," including an organization's public benefit activity and any support, allowances, and fees received in connection with it, and the sale of assets or inventories serving solely the organization's public benefit activity. The concept of public benefit is nonetheless significant in the taxation of NGOs, because the level of tax benefits that an organization is entitled to receive depends upon the degree of public benefit activity it pursues.

Public benefit organizations exempt. A second approach is to exempt only those organizations that engage in public benefit activities. Five countries – Albania, Bulgaria, Estonia, Poland, and Slovenia – and Kosovo exempt from income or profits taxes only organizations that engage in activities that serve some type of public

15 The Czech Republic exempts income from some sources, and taxes income from economic activities under a tax reduction scheme. The Czech rules relating to the taxation of income by its source, including the tax reduction scheme, are explained *infra* § II.A.2.

16 Hungarian law provides for two categories of public benefit organizations and grants them different levels of benefits. Both categories are entitled to greater tax benefits than NGOs that do not qualify as public benefit organizations. A "public benefit organization" may be a foundation, association, public law foundation, public law association, or public benefit company, and must pursue a public benefit activity listed in the law. It may pursue economic activities only to realize its public benefit purposes. *See infra* § II.A.2. A "prominently public benefit organization," which is entitled to greater benefits, must in addition undertake duties that are ordinarily considered state or local government duties. Hungarian law also provides for public benefit corporations, which can have both business and public benefit activities, but cannot distribute profits.

17 *See infra* § II.A.2.

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benefit, and list the activities in which such organizations must engage in order to claim the exemption. While organizations engaged in charitable, humanitarian, scientific, and educational activities are most frequently exempt from tax, some countries also exempt NGOs performing other types of activities, including amateur sports and political activities.

For example, in Albania, the law provides that "legal entities that carry out religious, humanitarian, charitable, scientific and educational activities," are tax exempt, provided that property or profits are not used for the benefit of founders or members.[18] Poland's list of exempt activities also includes environmental protection, cultural activities, and rural infrastructure support. In Slovenia, associations, religious communities, private and public funds, and other organizations and institutions established for ecological, humanitarian, charitable and other nonprofit purposes are exempt, except to the extent that they conduct economic activities.

In Bulgaria the law governing establishment of foundations and associations provides that the government may support public benefit NGOs through tax and other benefits established in relevant legislation. Public benefit purposes defined by the law include health; science; education; the development and establishment of spiritual values, civil society, engineering, technology, or physical culture; the support of the socially vulnerable, needy, or handicapped; the support of social integration and personal advancement; and the protection of human rights and the environment.[19] In Kosovo, an NGO may obtain public benefit status if its principal activities include one or more of the following: humanitarian assistance and relief, charity, education and health (if significant benefits are provided free of charge or at less than fair market value to disadvantaged individuals or groups); culture, environmental conservation or protection, economic reconstruction and development (if undertaken primarily for the benefit of disadvantaged individuals or groups), the promotion of human rights, the promotion of democratic practices and civil society, the promotion of gender equality, or any other activity that serves the public benefit.

More limited exemptions/reduced rates on certain types of income. The Republic of Srpska and Macedonia provide more limited tax exemptions. In the Republic of Srpska, "legal entities that engaged in labor and professional rehabilitation and

18 Income Tax Law, No. 8438, Art. 18. Albania has adopted framework legislation governing NGOs. *See* Law on Non-profit Organizations, No. 8788 (May 7, 2001); Law on the Registration of Non-profit Organizations, No. 8789 (May 7, 2001); Law for Some Additions and Amendments to Law No. 7850, Dated 29.07.1994 "The Civil Code of the Republic of Albania," No. 8781 (May 3, 2001). The Law on Non-profit Organizations, Article 40, states that "relief and exemptions of non-profit organizations from tax and customs obligations are set by law." The tax law has not been amended since the enactment of the new framework legislation. In practice, the tax authorities have extended the exemption to all NGOs and have not required a showing that an NGO engages in the listed activities.

19 The tax laws have not yet been amended to provide the benefits referred to above.

employment of disabled persons" are exempt from corporate income tax. NGOs engaged in these activities are thus exempt, but other NGOs are subject to the corporate income tax. In Macedonia, while the 1998 Law on Citizens' Associations and Foundations provides that all associations and foundations may claim the tax exemptions provided by law, the exemptions available under the tax laws are quite limited. The Law on Profits Tax applies to all legal entities that realize profits, and does not provide any exemption for NGOs. Similar to the Republic of Srpska system, the only organizations exempt from tax under all circumstances are centers that provide shelter to disabled people. Other legal entities may be eligible for a reduction in their tax bases depending on the source of their income and the purpose of their expenditures.

Summary – Organizations Entitled to Claim Exemptions

Exempt Most NGOs	Czech Republic, Croatia, Federation of Bosnia & Herzegovina, Hungary, Latvia, Lithuania, Romania, Serbia & Montenegro, Slovakia
Exempt NGOs with Public Benefit Activities	Albania, Bulgaria, Estonia, Kosovo, Poland, Slovenia
More Limited Exemptions	Macedonia, Republic of Srpska

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2. SOURCES OF INCOME EXEMPT FROM TAX

The laws of the region also address the types of income that are not subject to tax.

a. *Income from Grants, Donations, and Membership Dues*

Income from grants, donations, and membership dues is typically exempt from tax in the countries of Central and Eastern Europe.[20] This practice is in accord with international good practice.[21]

b. *Income from Economic Activities*

Income from economic activities is subject to divergent tax treatment in the countries of Central and Eastern Europe. Of those countries that permit NGOs to engage in economic activities, several tax the profit from such activities in full. The others provide an exemption for certain income from economic activities and use a variety of means to define criteria for exempting income from tax.[22]

Economic activities can be defined as "regularly pursued trade or business involving the sale of goods or services and not involving activities excluded under some distinct tradition."[23] Generally, this definition is understood to exclude the receipt of gifts and donations (see above), certain passive investment income, occasional activities such as fundraising events, activities carried out using volunteer labor, and fees that are "intrinsically connected to the public benefit purposes of the organization" (*i.e.,* tuition for an educational organization.)[24]

Consideration of the tax treatment of income from economic activities by NGOs presents two distinct questions:

20 One exception is Kosovo, where organizations without public benefit status are taxed on all income, including grants, donations, and dues, in excess of expenses. In Macedonia, the Law on Profit Tax provides that income of a legal entity from a "budget or fund assigned for performance of its activity" will not be included in the tax base for purposes of calculating the profit tax. Funds from special accounts and funds obtained from earmarked donations, membership fees, and certain others funds are considered "funds assigned for performance of its activity." The taxpayer must make a decision about the use of such funds, its financial plan and program, and the procedure and deadlines for utilizing those funds. "Income of a legal entity from a budget or fund" is not defined in the law. However, it is generally understood to include any type of income that is strictly designated for carrying out the legal person's activities. Accordingly, all grants, donations, and membership fees are treated as tax exempt.

21 Information regarding the laws of the surveyed countries pertaining to taxation of grants, contributions, and membership dues is summarized in Exhibit C.

22 The laws of the surveyed countries pertaining to taxation of income from economic activities are summarized in Exhibit D.

23 International Center for Not-for-Profit Law, "Economic Activities of Not-for-Profit Organizations," in *Regulating Civil Society,* conference report, (Budapest: May 1996), pp. 6-7 [reprinted at www.icnl.org]; ("Economic Activities"); Lee Davis and Nicole Etchart, *Profits for Nonprofits: An Assessment of the Challenges in NGO Self-financing,* (Santiago, Chile: NESsT 1999), pp. 72-73. Note that what constitutes economic activity is frequently undefined in the laws of the region.

24 Ibid.

(1) Should NGOs be allowed to engage in economic activities, and, if so, to what extent?

(2) Under what circumstances should the income from such activities be taxed?

International good practice suggests that NGOs should certainly be allowed to engage in, and earn income from, economic activities as a means of supporting their public purposes.[25] Obviously, however, there needs to be some limitation on the extent to which NGOs can engage in business activities and still be considered NGOs, for an organization that engages primarily in business would appear to be much like a for-profit enterprise and should be treated as such. At a very basic level, the ability of NGOs to act as commercial enterprises is limited by the laws governing their registration and operation, which generally require that they be organized as not-for-profit organizations as defined by law, and that they comply with the nondistribution constraint. Thus, all profits, even from economic activities, must be retained to support the NGO's operations, and may not be distributed as such to any person. However, the countries in the region generally impose additional restrictions on the permissibility of NGO economic activities. They permit an NGO to engage in and earn income from economic activities, but impose a limitation that the organization use the income from its economic activities to support its statutory goals.

Permissibility of Economic Activities: Almost all countries in the region permit at least some NGOs to engage directly in economic activities. In most cases, the laws contain the limitation that the purpose of these activities must be to support the goals set forth in an organization's statutes. For example, in Croatia, associations may engage in economic activities identified in founding documents and necessary to accomplish their statutory goals, while foundations may engage in economic activities in order to increase the value of property, which may only be used for pursuing their statutory goals.

In Romania, the law allows associations and foundations to engage directly in economic activities if they are accessory and are closely related to the organization's primary purpose. Under its Law on Legal Persons with Nonprofit Purposes, Bulgaria permits NGOs to engage in economic activities if they are additional and related to the subject of their registered statutory objectives. The revenue must be used to achieve a statutory purpose. Other jurisdictions requiring that income from economic activities be used to support statutory goals include Bosnia & Herzegovina, the Czech Republic, Estonia, Kosovo, Serbia & Montenegro, Slovakia, and Slovenia.

Albania, Hungary, Latvia, Poland and Slovenia, in contrast, have articulated their limitations on NGO economic activities in a slightly different manner. In Hungary, Albania, and Slovenia, the requirement that income be used to support statutory

25 See Tax Preferences, *supra* note 4.

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purposes is joined with a requirement that an NGO not be established for the primary purpose of pursuing economic activity.[26] Poland permits economic activities by NGOs where they are primarily for a *public benefit* purpose.

Two countries–the Czech Republic, and Slovakia–distinguish between foundations and other types of NGOs with respect to the permissibility of business activities. In the Czech Republic, associations and public benefit companies are allowed to engage in economic activities, but foundations and funds are limited to certain types of activities, such as renting property and organizing lotteries or collections. Similarly, in Slovakia, foundations and noninvestment funds are prohibited from engaging in business activities.

Two countries are exceptions to the general trend of permitting NGOs to engage directly in economic activities. In Macedonia, foundations and associations may not engage in economic activities directly. In order to engage in income-generating activities to support their not-for-profit purposes, they must found separate joint stock or limited liability companies. These separate subsidiaries are subject to the same tax rules as other commercial enterprises. Similarly, in Lithuania, associations and charity and sponsorship foundations are prohibited from engaging directly in a trade or business (although societal organizations, public institutions, and religious communities are not). Any business activities by associations and charity and sponsorship foundations must be conducted through a separate company.

Taxation of Income from Economic Activities: In determining how income from economic activities should be taxed, several approaches are available:[27]

(1) All income is taxed.

(2) The "relatedness" test, under which a tax is imposed only where the activities generating income are unrelated to the organization's public benefit purposes. The United States, which imposes an "unrelated business income tax,"[28] is an example of a country adhering to this approach.

(3) The "destination of income" test, under which all income from economic activities that is used to support the organization's public benefit purposes is exempt. This approach is employed in, e.g., Germany, where the law provides that income from a business activity is taxable unless the activity directly serves to realize the NGO's purpose.[29]

(4) A "threshold" or mechanical test, under which all business income above an established threshold is taxed.

26 In Hungary, foundations and civil society organizations may only pursue business activities in order to achieve their objectives.

27 For a more extensive discussion of the advantages and disadvantages of each of these rules, *see* Economic Activities, *supra* note 22, p. 9-16; The World Bank Handbook, *supra* note 4, pp. 105-06 and Appendix V.

28 *See* 26 U.S.C. § 511, et seq.

29 Schauhoff, Stephan, "The Economic Meaning of Not-for-Profit Organizations," in *Cahiers de Droit Fiscal International,* vol. LXXXIVa (The Hague: Kluwer Law International 1999), p. 430.

(5) Hybrid tests, which combine elements of the foregoing rules.

No exemptions: Of the fourteen countries in the region that permit NGOs to engage in at least some business activities, three – Albania, Bulgaria, and Slovenia – as well as the Republic of Srpska, tax the income from such activities in full. In Bulgaria, for example, the Corporate Income Tax Act of 1997 defines income as including "dividends, [returns on] equity, interest payments, positive balances from sales of immovable property, movables, and financial long-term assets, royalties, fees for technical services, and rental payments." All income is subject to a profits tax. In Albania, the Law on Non-profit Organizations explicitly permits NGOs to engage in economic activities – a marked departure from prior law, which prohibited economic activities – but the tax laws have not been amended since the enactment of the law in 2001. Since the tax law does not provide for exemptions, income from NGO economic activities is taxed on the same basis as the income of other legal entities. In the Republic of Srpska, NGOs, other than those engaged in labor and professional rehabilitation and employment of disabled persons, are subject to the corporate income tax on income from their economic activities. In Slovenia, NGOs are not exempt from income tax if they carry out business or economic activity. The tax authority determines on a case by case basis whether an income or expenditure is generated from economic activity, and thus subject to tax.

Exemptions available: Ten other countries in the region, and Kosovo, provide an exemption from tax for at least some income from economic activities; the countries are Bosnia & Herzegovina, Croatia, the Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Serbia & Montenegro. Of these, only the Federation of Bosnia & Herzegovina, Latvia, Lithuania, Kosovo, and Poland, employ one of the tests listed above strictly. The majority have elected to combine aspects of various tests to determine which income from economic activities is exempt and which is taxable.

No tax: In the Federation of Bosnia and Herzegovina, NGOs are not subject to the corporate income tax, and their income from economic activities is therefore not taxed.[30] In Lithuania, all non-profit entities are exempt from profit tax; only societal organizations, public institutions and religious communities may engage in business activities, however.

Relatedness Test: Latvia applies a "relatedness" test. Income from business activities related to the organization's statutory purposes is exempt, while income that is unrelated is taxed on the same basis as the income of for-profit businesses.

30 In the Federation, banks and other financial organizations, insurance corporations and cooperatives, and "institutions that engage in sale of goods and rendering of services on the market" are subject to corporate income tax law. NGOs have generally not been understood to be one of these types of organizations, and as a result have been considered exempt from corporate income tax. However, the precise meaning of the term "institution" is unclear, leaving some ambiguity with respect to the application of the corporate income tax to NGOs.

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Destination of Income Test: Under the law of Poland, income from business activities, like other NGO income, is exempt to the extent that it is dedicated to the pursuit of public benefit activities specified in the law. Similarly, NGOs in Kosovo with public benefit status are exempt to the extent that the income is used for public benefit purposes.

Hybrid Tests: The majority of countries now employ hybrid rules for determining when income from economic activities will be taxed. These countries have rules that employ some aspects of the destination of income or relatedness tests, but combine them with other conditions. For example, in the Czech Republic and in Serbia & Montenegro, the destination of income test is combined with income thresholds below which all business income is exempt. In the Czech Republic, NGOs are entitled to an exemption for income from business activities below CZK 300,000 (approximately EUR 9,400). Income above that amount is subject to a 30 percent tax deductible allowance up to CZK 1 million (EUR 31,400), provided the tax savings are used to fund expenses in connection with or to advance the organization's tax exempt activities. In Serbia, profits generated from an organization's economic activities are exempt from tax if they meet five conditions: 1) the profits do not exceed YUN 300,000 (approximately EUR 4,500); 2) profits are not distributed to the organization's founders, employees, members of the board, or persons affiliated with them; 3) salaries of board members and employees do not exceed double the amount of the average salary paid in the field of economic activity in which the organization is engaged; 4) all earned profit is used to further the objectives for which the organization was created; and 5) the NGO's economic activities do not hamper competition with the private business sector as defined by the competition law. In Montenegro, the profit from an organization's economic activities is exempt from tax as long as it does not exceed EUR 4,000 and is used to further the organization's statutory objectives.

In Slovakia, income from related activities up to SKK 300,000 (EUR 7,300) is exempt. A related business activity is one that is not defined in the organization's statutes as its primary purpose, but is necessary to ensure that the organization's statutory activities are carried out.

In Hungary, the corporate tax law states that for foundations, public foundations, civil society organizations, and public chambers, business activity does not include a public benefit activity or sales of assets or inventories serving solely a public benefit activity. If the NGO is not a public benefit organization, business activity excludes activity in connection with the organization's statutory purposes, or sales of assets or inventories serving solely such an activity. Income from these activities is thus not subject to tax. Income from other economic activities that does not exceed specified thresholds is treated as exempt; the thresholds are different for different types of organizations, depending on the level of public benefit status. Non-public benefit

organizations are entitled to exemption for business income that does not exceed 10 percent of total income or HUF 10 million (approximately EUR 39,400). Ordinary public benefit organizations are entitled to an exemption for such income that does not exceed 10 percent of total income or HUF 20 million. "Prominently" public benefit organizations are entitled to an exemption for such income up to 15 percent of total income. Public benefit companies are entitled to an exemption on taxable income above the 10 percent threshold in the proportion of income from "preferential" (tax exempt) activities to overall income.

In Romania, if a foundation or association conducts economic activities as well as charity or sponsorship activities, the organization may claim a tax deduction for expenses incurred in charity or sponsorship activities calculated in accordance with the tax law up to 5% of the difference between annual gross revenues and gross expenditures. The deduction is applicable as long as the expenditures are for a qualified purpose (i.e., one that is legal and not-for-profit in nature). Where an NGO performs economic activities apart from its nonprofit purposes, the exemption is applicable only if the income does not exceed EUR 10,000 per year (in RoL equivalent), and does not represent more than 10% of total non-taxable revenues.[31]

Under Croatia's Corporate Income Tax Law, income generated from a qualified NGO's economic activities may be subject to tax if exempting that income would result in the NGO's gaining an "unjustified privileged position in the market." The Tax Administration, on its own initiative or upon the request of a taxpayer or other interested person, may determine on a case by case basis whether to tax income generated from an NGO's economic activities. This essentially means that that income from economic activities will not be taxed, as long as the Tax Administration does not determine that the aforementioned condition is fulfilled. However, it is not yet clear how the Tax Administration will interpret the "unjustified privileged position in the market" language of the new law, and what types of activities will be considered to afford such a position to an NGO. Those organizations that are found to have an "unjustified privileged position" will be taxed on gross profit at the rate of 20 percent.

31 NGOs are exempt from tax for the following categories of revenues in addition to registration fees, donations and sponsorships: revenues from shows and exhibitions, financial resources obtained from state or local budgets, incomes resulting from activities of trade unions or shareholders' unions used for social or professional purposes, and incomes resulting from assignment of assets held by NGOs that are not used for a business purpose.

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Summary of Exemptions for Income from Economic Activities

Prohibit direct economic activities	Lithuania (Associations and charity and sponsorship foundations), Macedonia
No subject to tax	Fed. of Bosnia & Herzegovina, Lithuania (Societal organizations, public institutions and religious communities)
Tax income from economic activities	Albania, Bulgaria Slovenia, Rep. Srpska
"Relatedness" test	Estonia, Latvia
"Destination of Income" test	Poland, Kosovo
Hybrid tests	Croatia, Czech Republic, Hungary, Romania, Serbia & Montenegro, Slovakia

c. *Investment Income*

In an increasing number of countries, investment income provides an important source of income for NGOs. Private foundations and universities invest large endowments, earning substantial income in the form of interest, dividends, and capital gains to support their activities. Other organizations earn rents from property investments, royalties from the sale of intellectual property rights, and dividends or interest from stock holdings, bank accounts, and other investments. However, because it is important that the resources of at least public benefit NGOs be devoted primarily to public purposes, countries that provide incentives for investments sometimes establish rules to prevent NGOs from accumulating excessive capital and to ensure that they are distributing their assets for appropriate purposes.[32]

32 Some countries have accumulation rules that require NGOs to spend a specified percentage of their income each year, thereby preventing capital accumulation. In Germany, for example, a foundation must generally spend all of its income within one year of receipt; the law does however permit some retention of capital to support larger investment projects. Other countries have minimum distribution rules designed to ensure that NGOs' resources are consistently devoted to public purposes rather than accumulated. The United States, requires that foundations spend an amount equal to 5 percent of their net investment assets each year, and imposes excises taxes on those that fail to meet this requirement. Note that these types of rules are not commonly found in the laws of the CEE region.

Conceptually, the tax issues related to such investments by NGOs are:

1. Should NGOs be permitted to earn income from passive investments?
2. How should the income from investments be taxed?
3. What limitations on, *e.g.,* accumulation of capital, distribution of income, and investment management should be imposed?

A wide variety of approaches to these issues exists in the region.[33]

Permissibility of passive investments: All countries in the region permit NGOs to earn income from passive investments.

Taxation of passive investment income – investment income taxed: The tax treatment of passive investment income varies not only by country, but also within countries by type of investment and type of NGO. Seven countries – Albania, Bulgaria, Czech Republic,[34] Latvia, Macedonia, Slovakia, and Slovenia – treat almost all investment income as taxable.[35] In Macedonia, for example, NGOs may generate income from investments directly, and are not required to form separate companies to receive income on interest, dividends, and rents (as would be required for income from economic activities). However, they are taxed on investment income at the ordinary 15 percent rate. Dividends and other income from participation in the profits of another taxpayer resident in Macedonia are not included in the tax base if they are taxed to the other taxpayer. Slovakia taxes investment income, but for interest on bank accounts and dividends, the tax is at a reduced rate of 15% (in contrast to the 25% rate imposed on stock earnings).

Partial exemptions and reductions in tax: Other countries either tax investment income of NGOs at a lower rate than similar investment income of businesses, or exempt income from certain types of investments from tax. Under Serbian law, for example, income generated from government bonds is tax exempt, as is income earned on an endowment. Dividends are taxed at the rate of 20 percent as long as an NGO is subject to corporate income tax law. In Montenegro, passive investment income up to EUR 4000 is exempt.

In Hungary, investment income is generally taxable. However, public benefit organizations are exempt on interest or yields from deposits or credit type securities in connection with their public benefit activities, as long as they do not engage in business activities. Non-public benefit organizations and public benefit companies, as well as PBOs engaging in business activities, are exempt on part of interest or yields in proportion to the ratio of income from targeted or public purpose activities to

33 The laws of the surveyed countries pertaining to investment income are summarized in Exhibit E.

34 One exception is for income from the registered endowment of a foundation, which is exempt, as discussed below.

35 Note that of these countries, Albania, Bulgaria, Macedonia, and Slovenia also tax income from NGOs' business activities, and thus are consistent in taxing most sources of NGO income other than grants, contributions, and dues.

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total income. All NGOs are also taxed proportionally on shares and stocks they own.[36]

Exemptions: Several countries have more generous exemptions for investment income. Poland exempts investment income used for public benefit purposes. In Kosovo, all NGOs with public benefit status are exempt on their income, including passive investment income. In Romania, interest and investment income is exempt from tax. In Lithuania, charity and sponsorship foundations are prohibited from engaging directly in a trade or business, but specifically are allowed to invest in governmental or municipal securities. Societal organizations, public institutions and religious communities may also invest. No tax is imposed on income from permissible investments, because all types of NGOs are exempt from the profits tax.

Endowments: In most countries in the region, the laws do not specifically address the creation of endowments or taxation rules for income earned from endowments. The Czech Republic and Slovakia are exceptions. In the Czech Republic, the Law on Foundations and Funds ("Law") provides that certain passive investment income derived from a registered endowment is not subject to taxation.[37] A registered endowment is that part of the foundation's assets that cannot be sold or purposefully diminished. The registered endowment may consist of monetary assets kept in a special bank account, state-issued or state-guaranteed securities, real estate, income-producing art objects, and certain intellectual property rights.

Periodic income in the Czech Republic, such as dividends and interest, generated by the registered endowment may be expended to support the foundation's activities, and is exempt from tax if it is used in accordance with the Law. If a foundation is to take advantage of the tax exemption for its income, then the investment income net of expenses must be incorporated into the registered endowment and entered into the register of foundations and funds as part of the registered endowment. Otherwise, the income will be taxed.

The Law contains limitations on administrative expenses that may be charged to the registered endowment, and requires that a foundation select among three administrative expense management levels. All changes in the amount of the registered endowment must be registered with the government. The Law limits the

36 In Bulgaria, there is a provision in the Corporate Income Taxation Law which reduces the corporate tax for legal entities by 10% of the amount of the contributions for establishment or increase of the company's capital. The reduction applies only in those municipalities with high unemployment rates listed in an annex to the law. When this reduction exceeds the amount of the tax, the variance is deducted over the next five years. To date, there has been little experience with the provision as applied to NGOs.

37 For further discussion of the Czech Law on Foundations and Funds, *see* Robert N. Thomas, "Structural and Systemic Issues Surrounding the Establishment and Management of Endowments in the Czech and Slovak Republics," 2 *International Journal of Not-for-Profit Law,* Issue 4 (June 2000)[www.icnl.org].

investment of assets of a registered endowment to state guaranteed instruments or special accounts with financial institutions. Capital gains are in any case taxed.[38]

The practical implications of this law are unclear, as a limited number of foundations and funds have been established under the new law since its enactment in 1997.[39] As a practical matter, the strict restrictions on investment described above may inhibit substantial earnings on endowments in the near term. Nonetheless, it is expected that this law will encourage the establishment of sustainable foundations.[40]

Slovakia also imposes restrictions on the endowment of a foundation. A foundation can invest its endowment only in state obligations, state bonds, securities traded on main markets, participation certificates, mortgage bonds, deposit receipts, deposit certificates and real estate.

Restrictions on distributions, accumulations: With the exception of the Czech Republic, where the Law on Foundations and Funds provides limitations on the types of investments that a registered endowment may make, the countries in the CEE region that permit passive investments by some or all NGOs do not generally restrict the types of investments that an NGO may make. Since the existence of endowments is not widespread, the laws of the region do not address restrictions on the types of investments and standards for managing endowments. Similarly, the countries in the region uniformly do not provide that endowed foundations must distribute a minimum portion of their assets,[41] or limit their capital accumulation.

3. Treatment of NGOs under Estonia's Integrated Tax System.

In a distinct departure from the tax practices employed by other countries in the region, Estonia eliminated its tax on the income of legal entities in favor of a tax on certain of their distributions. Thus, legal entities now pay tax on distributions that

38 The Czech Republic in 1991 created the Foundation Investment Fund to support foundation endowments, and allocated shares from a privatization round to the Fund. In 1999, the Chamber of Deputies of the Parliament approved a government proposal to distribute CZK 500 million from the Fund to 39 foundations. In December 1999, the Chamber of Deputies approved a government proposal for rules for a second round distribution. The formation of the fund was in part the motivation for reform of the foundation laws. Jirí Műller, "The Economic Environment for the Civil Nonprofit Sector in the Czech Republic: Foundations and Assets" (conference report) (Brno, Czech Republic: May 2000), pp. 28-31; Petr Pajas, "Endowments of Foundations Receive Contributions from the State Privatization Fund of the Czech Republic," ("Endowments") [*reprinted at* www.icnl.org].

39 *See* Műller, *supra* note 39, p. 25.

40 Pajas, Endowments, *supra* note 39. Otherwise, in the Czech Republic, investment income is generally fully taxable. Associations may not be established for entrepreneurial purposes, but the law does not specifically prohibit investment in the business activities of other persons. Public benefit corporations, on the other hand, are strictly forbidden from taking part in commercial activity by other persons; this means that these organizations may not invest in securities.

41 *See, e.g.,* 26 U.S.C. §4942.

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they make in the form of salaries and fringe benefits paid to natural persons, gifts and charitable contributions, dividends and other distributions of profits, and "non-enterprise expenses."[42] NGOs are not exempt from this tax. Nonetheless, certain organizations that serve a public benefit are entitled to tax benefits, in that some distributions to them are not taxable to the payer. In order for the payer of the distributions to receive the tax benefits, the recipient organization must be (1) entered on a government list of nonprofit organizations; (2) entered in the register of religious associations; (3) own a hospital; (4) qualify as a state or local government scientific, cultural, educational, sports, law enforcement, or social welfare institution; or (5) be a manager of a protected area. To qualify for entry on the list of nonprofit organizations, an NGO must engage in specified public benefit activities (including education, charity, science, culture, health care, and social welfare, among others), limit its administrative expenses, and meet certain other conditions.

The tax on distributions is at the rate of $^{26}/_{74}$ and applies to NGOs as follows.[43] In Estonia, NGOs, like other employers, pay tax on fringe benefits furnished to their employees. NGOs, like other legal persons, pay the tax on gifts and contributions made to NGOs that are not on the government list.[44] A contribution, such as a grant, by one organization on the list to another on the list is not considered to be a taxable distribution. However, contributions, even by a public benefit organization, to an organization that is not on the list will be taxed to the donor. When an NGO (or other legal entity, see *infra* §C.1) not on the list makes a gift to an organization on the list, it pays the tax on the amount exceeding 3 percent of the amount subject to the social tax (essentially, employee remuneration), or 10% of profits for the last financial year of a taxpayer dissolved as of January 1. If an NGO makes a gift to a natural person, the gift is taxed unless it is pursuant to a foundation's statutes, in which case it is not taxed.

Commercial entities pay the tax on their dividend payments and other distributions of profits; however, such distributions made to NGOs on the government list

42 The purpose of Estonia's income tax reform was to make foreign investment in the Estonian economy more attractive, while reducing tax fraud and evasion. *See* Letter of Siim Kallas, Minister of Finance, to Taxpayers, "Implementation of the Income Tax Act" [www.fin.ee/] (April 25, 2000). The drafters view the reform as instituting a new principle of calculation of income tax, rather than an elimination of the corporate tax. Rather than taxing legal entities on profits, and shareholders on dividends and capital gains, Estonia imposes a unified tax on corporate distributions. Thus, any income retained by a legal entity for use in its business is no longer subject to tax, creating an incentive for such investment. Estonian law also provides for a flat tax of 26 percent on the income of individuals, with limited deductions, including a deduction for contributions to NGOs. *See infra* § II.C.2.

43 The rules discussed here pertain to legal entities resident in Estonia. The rules for nonresident legal entities with a permanent establishment in Estonia are for the most part similar, although there are some additional provisions pertaining to their taxation.

44 This rule thus preserves tax benefits for donations to public benefit NGOs, and is discussed in more detail in § II.C., *infra,* which deals with tax benefits for contributions.

are not considered taxable distributions.[45] Thus, if a corporate profit distribution is made to an NGO on the government list, it is not taxable. A corporate distribution made to an NGO that is not on the government list is subject to tax.

Estonia also taxes certain expenditures made in connection with economic activities by NGOs. Expenditures made in connection with activities that are unrelated to an NGO's statutory purposes are considered non-enterprise expenses, or taxable distributions, by the organization on which it must pay tax.

B. EXEMPTIONS FROM OTHER TAXES

1. Real Property Taxes (Including Land Use and Building Taxes)

The majority of the countries – nine – surveyed for this study provide for broad exemptions of organizations with public purposes from taxes on real property, including land and buildings. These countries are the Czech Republic, Hungary, Latvia, Lithuania, Macedonia, Poland, the Republic of Srpska, Romania, Serbia & Montenegro, and Slovakia.[46]

In the Republic of Srpska, the real estate of religious organizations and those NGOs that pursue certain public benefit goals (educational, cultural, scientific, social, medical, humanitarian and sport) is tax exempt to the extent that the property is used to advance the organization's statutory goals. Similarly, in Serbia, real estate that is used for "educational, cultural, scientific, social welfare, medical, humanitarian and sport purposes" is exempt from taxes, as is the property of religious organizations used for religious purposes.

In the Czech Republic, lots with buildings used for ceremonies of churches and religious societies, owned by associations or public benefit corporations, or used by schools and educational establishments, museums, art galleries, public libraries, state archives, health or social care institutions, and foundations and funds, are all exempt from the land use tax. Similarly, Latvian law exempts from real estate taxes religious organizations, public cultural associations, and other public organizations, immovable property used for health protection, sports, public education, and cultural needs, environmental and fire protection. However, public organizations pay tax on that part

45 Note that under this law a distribution from one legal entity to another generally is not taxable, since the profits of both are free from tax. Profit distributions to individuals and not-for-profit organizations that are not on the government list, however, are subject to tax. NGOs are prohibited by virtue of the nondistribution constraint from making profit distributions, and should not themselves be making dividend and profit distributions that would subject them to tax. NGOs, like other legal entities, must report monthly their taxable distributions.

46 The laws pertaining to real property, gift and inheritance, and other taxes are summarized in Exhibit F.

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of property used for business purposes. Lithuania also exempts most NGOs from real estate taxes, including charity and sponsorship funds, societal organizations, associations for the disabled, educational, social welfare, environmental protection, and religious organizations. Macedonia exempts from the property tax buildings and land used for, among other things, educational, cultural, scientific, social, health care, humanitarian and sports purposes, the Macedonian Orthodox Church and other religious organizations, and workplaces that employ the disabled, except those buildings or parts of buildings and land that are economically exploited or leased.[47] In Slovakia, exemptions from "feu" duties and construction and apartment taxes are available for property devoted to various public purposes, such as culture, education and social services, as long as the property is not used for business activities, including rentals.

Other countries exempt more limited categories of NGOs from real estate taxes. In Bulgaria certain organizations, such as the Bulgarian Red Cross and community centers (*chitalishta*), are entitled to tax exemptions provided that the real estate subject to tax is not used for economic goals unrelated to the main activity of the organization. Croatia exempts the Red Cross and similar humanitarian organizations, funds and foundations, and not-for-profit medical institutions, from the 5 percent capital transfer tax that applies to all real estate transactions that occurred before January 1, 1998.[48] In Romania, the following are exempt from real estate tax, except to the extent that space is used by a for-profit business: buildings housing public institutions, historical, architectural or archaeological monuments, museums or memorials, buildings used for religious organizations, and buildings belonging to testamentary foundations with missions to promote national cultural institutions or humanitarian, social, or cultural activity. Real estate taxes can be increased or decreased up to 50% by decisions of county councils. Poland exempts from real estate taxes only associations that engage in activities for the benefit of youth (i.e., education, sports, recreation, and science), to the extent that they do not use the property for economic activities.[49]

A few of the countries permit narrow exemptions from real property taxes for NGOs. In Albania, most organizations are subject to tax on real property, except for certain international organizations and disaster relief organizations designated by the Council of Ministers. In Slovenia, diplomatic and consular representation, international organizations, and religious organizations are exempt from paying the tax on real property. In Estonia, there are no property tax exemptions for NGOs.

In the Federation of Bosnia and Herzegovina, taxation of real estate is the subject of cantonal jurisdiction. In the canton of Sarajevo, for example, only religious organizations are exempt from taxes on real property, and only to the extent that they use the property to advance their statutory goals.

47 Note, however, that in Macedonia the Law on Property Tax imposes both a tax on the value, from which certain specified organizations are exempt, and a tax on real estate and the rights thereto when the property is transferred for a price or exchanged for remuneration. NGOs are not exempt from this tax.

48 Real estate transfers that occurred after January 1, 1998 are taxed under the VAT.

49 Although other organizations must pay tax, the tax on plots and buildings not used for business activities is relatively low.

2. Gift and Inheritance Taxes

In many of the countries studied in the survey, neither NGOs nor their donors pay taxes on gifts or bequests, either because there is no gift or inheritance tax, or because gifts or bequests to certain NGOs are exempt from the tax. Three of the countries covered by this survey – Albania, Estonia, and Romania – and Kosovo do not have gift or inheritance taxes.[50] In Poland and Lithuania, these taxes apply only to natural persons.[51] In Bulgaria, Croatia, the Czech Republic, Hungary, Macedonia, Montenegro, and Slovakia, gifts and bequests to NGOs are generally exempt from these taxes. In Hungary, gifts and inheritances for public benefit purposes are exempt. In Bulgaria, registered PBOs are exempt from gift taxes, as are the Bulgarian Red Cross, national organizations for the disabled, funds used to assist victims of natural disasters, funds used for the restoration of historical and cultural monuments, and Bulgarian educational, health, cultural, and scientific organizations on a state budget subsidy. If, however, property received is transferred and the transaction is not pursuant to the performance of the statutory purposes for which the organization is established, the 5% gift tax will be imposed on the organization, regardless of its form and purpose. Similarly, in Macedonia, organizations of the Red Cross, humanitarian and social institutions, scientific, educational, and cultural institutions and religious communities, are exempt for gifts received in the form of movable or immovable property, financial resources, and claims. In Croatia, the Red Cross and other humanitarian organizations, as well as associations, funds and foundations, and not-for-profit medical institutions are exempt from the gift and inheritance taxes. In the Czech Republic, the following are exempt: gifts of property to legal entities with their seats in the Czech Republic established to conduct activities in the fields of culture, education, science, learning, health and social care, fire protection, ecology, physical culture and sports, education and protection of children and young people, and to finance these activities; registered churches and religious societies/congregations; public benefit corporations, if the property serves their main

50 Estonia has no gift tax *per se*. However, gifts by legal entities to not-for-profit organizations that are not public benefit organizations on the government's list are taxable distributions. See *supra* at § II.A.3.

51 NGOs may be subject to income or profits tax, however, on revenue from certain gifts. In Lithuania, a gift or bequest to a not-for-profit organization is considered income from non-business activity and is taxed at the 5 percent reduced rate unless the law governing tax exempt income applies. In Poland, gifts and inheritances create income for corporate income tax purposes. NGOs are exempt from tax on gifts and estates as long as the income is used for a specified public benefit purpose.

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activity; foundations and funds; and recipients of grants provided by foundations or funds. In Slovakia, gifts and bequests are exempt if used to develop foundations, churches and religious communities, culture, schools, science, healthcare, school care, ecology, physical training and sports, as well as inland communities, state archives, and humanitarian and charity unions. The Montenegrin law exempts NGOs regardless of whether they pursue public or mutual benefit activities.

In the other countries, the exemptions from the gifts and estate taxes are more limited, *i.e.,* the exemption applies to narrower categories of organizations, or are not allowed. In Serbia, gifts or inheritances received by legacies[52] and foundations are exempt. In the Republic of Srpska, only gifts to and inheritances by foundations and funds are tax exempt. In Slovenia, taxpayers do not pay tax on inheritances and gifts if the inherited or gifted property is transferred to the Republic of Slovenia, the local community or to humanitarian associations and their unions. Latvia permits no exemptions from either the tax on inheritance or on gifts for gifts received by NGOs.[53]

3. Value Added Tax (VAT)

All countries in Central and Eastern Europe impose a value added or a turnover tax upon the sale or transfer of goods and services. The treatment for NGOs under VAT regimes varies widely.[54]

There are several ways in which VAT may be applied to NGOs. One option is to exempt NGOs from the VAT system. This option ensures that NGOs do not have to collect and pay over VAT on goods and services that they provide, and they thus do not incur compliance costs (i.e., for accounting and reporting.) Unfortunately, they are also unable to obtain rebates for the VAT that they pay for the goods and services that they purchase. As a result, this is not an approach that is particularly beneficial to NGOs.[55] Another option is to "zero-rate" goods and services. In other words, if the general VAT rate is 20 percent, NGOs (and others) will collect and pay over nothing on the zero-rated goods and services that they provide. They will have

52 A legacy is a pool of property established by a natural person to pursue public benefit goals. A legacy is a legal entity and must be registered. A legacy differs from a foundation in that it can only be established by a domestic or foreign natural person, whereas a foundation may only be established by a domestic legal person. Serbian law also provides for funds, which can be established by either domestic or foreign natural persons, or domestic legal persons.

53 In the Federation, taxation of gifts and inheritances is the subject of cantonal jurisdiction; there are no gift or inheritance taxes at the Federation level. In the canton of Sarajevo (Federation), for example, gifts to and inheritances received by NGOs are tax exempt to the extent that they are used to advance the organization's statutory goals, regardless of whether the organization pursues public or mutual benefit goals.

54 The laws pertaining to VAT are summarized in Exhibit G.

55 *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.

to pay the 20 percent VAT tax included in the price of the goods and services they purchase, but they may seek rebates for those amounts. This is generally considered a more beneficial option for NGOs.[56] Other approaches include according preferential, rather than zero, rates on certain goods and services, and exempting certain transactions from VAT. All countries in the region have a monetary threshold below which an organization need not register for inclusion in the VAT system.

Exempt organizations: Several countries in the CEE region take the approach of exempting either all or some NGOs from the VAT system. The exemption is generally limited to the extent that either a) the NGO engages in activities other than public benefit activities, or b) the NGO engages in commercial activities. Countries in this category include Bulgaria, Croatia, the Czech Republic, Macedonia, and Romania, as well as Montenegro. Croatia exempts from VAT religious organizations and the Red Cross, as well as political parties, trade unions, trade chambers, and most domestic humanitarian organizations. Also, Croatia's VAT law provides for a "tax holiday," or exemption, for not-for-profit organizations that receive foreign donations of goods or services, as well as for in-country purchases financed by foreign financial aid. The law also provides an exemption for independent artists and artistic organizations. Macedonia does not, as a general matter, exempt NGOs, but cultural organizations, botanical gardens, zoos, parks, archives, and documentation centers are exempt.

Montenegro's newly implemented VAT law[57] provides a broad exemption for all services provided by NGOs, provided that the exemption is not used to distort market competition. Services of "public interest," including educational, cultural, sporting and religious services, are also exempted from VAT. Foreign grants and donations are not subject to VAT. In addition, any organization with an annual turnover of less than EUR 18,000 is exempt from paying VAT. This effectively removes a large number of NGOs from the VAT regime.

Exempt transactions: 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. Countries in this category include Albania, Bulgaria, Estonia, Hungary, Latvia, Lithuania, Macedonia, Poland, Slovakia, and Slovenia. 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. In Albania, for example, many goods and services frequently supplied by NGOs are exempt from VAT, as long as these goods are supplied without charge or for charges clearly less than they would be if supplied on a for-profit basis. In Bulgaria, donations to NGOs are exempt from VAT; a number of transactions are exempt, as are import transactions relating to certain foreign aid. Lithuania exempts goods

56 This option may be limited in those states seeking EU accession, however. *See infra* note 73 regarding harmonization of VAT in the EU.

57 The VAT system went into effect on April 1, 2003. Prior to this date, a turnover tax was in effect.

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imported as charity from import VAT, and further exempts goods and services such as social, cultural, and educational services, and medical technology, among others. In Macedonia, gifts by foreign donors to public institutions and registered Macedonian humanitarian organizations are exempt. Poland's VAT law contains a list of goods and services that are exempt, including services in the fields of scientific, technical, and economic information, research and development, education, health protection and social welfare. In Slovakia, activities exempted from VAT include educational, training, scientific, healthcare, and social care services. Slovenia's list of exempt transactions includes the sale of goods and services by not-for-profit organizations with political, trade union, religious, patriotic, philosophical, humanitarian or civil purpose in return for a membership fee, if it is not likely that such an exemption would cause unfair competition. Hungary and Latvia also exempt goods and services provided for specified public purposes.

Zero and preferential rates: Zero and preferential rates are less frequently used in the region. Hungary and Poland use zero or preferential rates to reduce the amount of VAT collected and owed on transfers of certain goods and services. These rates are not imposed specifically on goods or services provided by NGOs. However, some of the goods or services subject to lower VAT rates are among those likely to be provided by NGOs (*e.g.,* education, health, welfare services). Poland applies a 7 percent preferential rate to many goods and services, including hearing aids, pharmaceutical products, certain medical and sanitary articles, rehabilitation products, and Braille devices. Hungary zero-rates pharmaceuticals, books for public education, and products for the blind, and biological diesel fuel, and affords a preferential rate of 12 percent to, *e.g.,* certain medical and pharmaceutical products, book, newspaper, and magazine publishing, performing arts, library services, professional sports, and zoological and botanical parks. In Slovenia, a reduced rate of 8.5% applies to sale and import of the following good and services: foodstuffs (including food services in restaurants), agricultural inputs, water supply, pharmaceutical products, medical equipment, accessories for the disabled, public transport, books, newspapers and periodicals, services of authors and composers, cultural events, sporting events and facilities, housing, hotel and like accommodation, and funerals and waste treatment. In the Czech Republic, a preferential 5% rate applies to trading of most food and agricultural products, many healthcare and health protection goods, services and equipment (including equipment for the handicapped), and books, journals, newspapers, small wind power generators, low consumption light bulbs and other products with a positive environmental impact. In Estonia, a preferential rate of 5% is applied to, e.g., certain books, medicinal products and medical equipment, organization of performances or concerts, or heat provided to natural persons, housing associations and churches. Estonia also applies a zero rate to certain goods and services, including transfers of goods or services to a domestic nonprofit organization on the government list or an organization on the register of religious associations if acquired with money received as foreign aid. Macedonia gives a preferential rate of 5 percent for the publication of brochures and periodicals. Croatia applies a zero-rate to scientific journals.

In Kosovo, VAT exemptions for NGOs, and for transactions often carried out by NGOs, are significantly more limited than in the rest of the region. NGOs with public benefit status are entitled to a rebate of VAT paid on imports on intra-FRY inflows, upon proof that the goods are used exclusively for the pursuance of their public benefit purposes. Excluded from VAT are imports, intra-FRY inflows or supplies funded from the proceeds of grants made to NGOs in support of humanitarian and reconstruction programs and projects in Kosovo; imports, intra-FRY inflows or supply of medicines, medical services or medical instruments; supply of public education services; supply of financial services; and transfer of title or lease of land or residential property. However, registration is not required for entities with turnover of less than 100,000 Euros, removing many organizations from the VAT regime.

Turnover taxes: Serbia and Bosnia & Herzegovina employ turnover taxes as opposed to VAT. These are essentially sales taxes, which have now been eliminated in most countries of the region in favor of VAT. In Serbia, NGOs are exempt from turnover taxes on goods as long as they are for the organizations' statutory activities; goods imported for aid by the Red Cross and domestic goods donated to the Red

Treatment of Value Added Tax for NGOs

Exempt organizations	Bulgaria, Croatia, Czech Republic, Macedonia, Montenegro, Romania
Exempt transactions	Albania, Bulgaria, Estonia, Hungary, Kosovo, Latvia, Lithuania, Macedonia, Poland, Serbia, Slovakia, Slovenia
Zero Rating	Croatia, Estonia, Hungary, Latvia, Lithuania, Romania
Preferantial Rates	Czeh Republic, Estonia, Hungary, Macedonia, Poland, Slovenia
Turnover taxes	Bosnia & Herzegovina, Serbia

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Cross are exempt.[58] In Bosnia & Herzegovina, the Red Cross and other humanitarian organizations, as well as religious organizations are exempt from turnover taxes on most goods if they are used to pursue the organizations' major statutory goals. In addition, services rendered by such organizations are exempt.

C. AVAILABILITY OF TAX BENEFITS TO DONORS FOR CONTRIBUTIONS TO NGOS

All 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 specified NGOs. Benefits may be available to both businesses and individuals.[59] In addition, Hungary, Slovakia, Lithuania, and Poland have enacted unique laws that permit taxpayers to designate 1 (or 2) percent of their taxes paid to be distributed to NGOs.

1. Benefits for Business Donors

All the countries in the region permit legal entities to claim benefits for certain donations to NGOs. These benefits are in the form of deductions in all countries except Latvia, which allows a tax credit to business donors. A few countries place limitations on the types of businesses that may deduct contributions. All limit in some fashion the amount of the deduction. In addition, all of the countries in the region limit the types of organizations to which tax-deductible donations can be made.

What types of organizations may claim benefits for donations? Generally, the countries in the region permit for-profit legal entities to claim deductions for their charitable contributions or their sponsorship of NGOs.[60] One country, Hungary, is more expansive; it permits not only corporations but also unincorporated associations and individual entrepreneurs to claim the tax deduction for contributions. A few countries limit the deduction. Albania allows only those entities that meet the definition of a "trader" (*e.g.,* enterprises and individuals engaged in commercial activity) to be sponsors that may claim deductions. The Croatian Law on Income Tax allows businesses to seek a deduction for contributions. It also permits businesses to receive a rebate for monetary or in kind gifts to qualifying NGOs on the grounds that they are permissible business expenditures. Sponsorships of NGOs are permissible business

58 A draft VAT law is currently under consideration in Serbia.

59 The laws pertaining to the availability of tax benefits for donations by individuals and legal entities are summarized in Exhibit H.

60 As this survey went to print, Slovakia enacted amendments to its Income Tax Act instituting, effective 2004, a flat tax of 19% on businesses and individuals, and abolishing benefits and allowances, including the tax deduction for donations to NGOs. Effective 2005, however, the 1% designation (see below) allowed to individuals and corporations will increase to 2%.

expenditures for tax purposes only if the sponsoring business receives a reciprocal benefit in the form of promotional services.

What types of organizations may receive tax-benefited contribution? The countries in the region generally limit the deduction to donations made to organizations recognized as public benefit organizations, *i.e.,* those that perform charitable, cultural, educational, religious, scientific, or humanitarian activities. The Czech Republic permits, in addition, donations to individuals who run schools and healthcare facilities or who care for abandoned animals or endangered species.

In Estonia, charitable contributions by legal entities to not-for-profit entities that are not on the government list of public benefit organizations are considered taxable distributions, regardless of whether they are made by an organization on the list, not on the list, or some other type of legal entity. Contributions to NGOs on the government list are taxed, but only if they are in excess of 3 percent of the amount subject to social tax. See below.

In Macedonia, donations for scientific, humanitarian, cultural, educational, health care, religious, and amateur sports purposes may receive tax-benefited donations, but only to the extent that the donations and grants are made to public organizations financed by the state budget or the Red Cross of the Republic of Macedonia.

In Kosovo, contributions made by businesses for humanitarian, health, education, religious, scientific, cultural, environmental protection, and sports purposes are allowed as expenses. However, the contribution need not be made to a public benefit organization, an NGO, or even a legal person. This provision has been criticized on the grounds that it permits the benefit of the tax deduction to flow to, e.g., shareholders and other business owners, because the organizations permitted to take the deduction are not necessarily subject to the non-distribution constraint.[61]

Limitations on the amount of the deduction. All of the countries in the region limit the amount of the deduction or credit that a legal entity may claim. The allowable deduction ranges from 0.5 percent of revenue (Bosnia & Herzegovina) to 40 percent of taxable income (Lithuania permits a deduction for two times the amount of the donation up to 40 percent of taxable income.)

In Bosnia, Macedonia, Serbia, and Slovakia, the deduction is limited to a percentage of gross income or revenue. These are: Bosnia (0.5%); Macedonia (3%); Serbia (3.5% or 1.5% for gifts for cultural purposes); and Slovenia (3%).

Other countries limit the deduction to a percentage of taxable income or profit prior to calculation of tax. In Croatia, for example, donations made by businesses (and individuals) to qualifying organizations are deductible up to 2 percent of the

61 Sponsorship is generally a donation given with the expectation that the donor will receive a benefit in the form of advertising. However, this definition is not uniformly accepted; in Albania, sponsorship refers to any kind of financial or material support provided by a qualifying donor, and donors are specifically prohibited from realizing any type of economic profit as a result of their donations.

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donor's income generated in the prior calendar year. This threshold may be exceeded on approval of the competent ministry. For example, if the Ministry of Education and Sport deems a particular project of an amateur sports organization to be especially beneficial, donations to that project may be as much as 100 percent deductible to the donor. Limitations in other countries include: Albania (4%, or 10% for publishing activities); Czech Republic (5%); Kosovo (5%); Romania (5%); Bulgaria (10%); Slovakia (10%); Poland (10 percent or 15 percent); Hungary (20 percent); and Lithuania (40 percent).

In Estonia, contributions by businesses to NGOs not entered on the government list that exceed 3 percent of payments subject to the social tax (essentially, employee remuneration) for the previous month are subject to tax, and thus only the amount up to 3 percent can be considered a tax-benefited contribution.[62] Legal entities must report monthly on their charitable contributions, but if an organization does not make contributions each month, it may recalculate its reported contributions at year-end to take greater advantage of the tax benefit.

Latvia alone among the countries in the region permits businesses to take tax credits for their donations. A donor may claim a credit of 85% of a contribution from gross income up to 20% of the wholly assessed tax liability. Donors to any of three privileged organizations – the Latvian Olympic Committee, the Children's Fund, and the Culture Fund – may claim a credit of 90% of their contributions. Only public organizations with the permission of the Ministry of Finance may receive tax-benefited contributions.

2. Benefits for Individual Donors

Seven jurisdictions in the region do not generally permit individuals to deduct for contributions to charity – Albania, Bosnia & Herzegovina, Kosovo, Lithuania, Macedonia, Romania, and Serbia.

Hungary, alone among countries in the region, grants a tax credit rather than a deduction for individual donations. However, the credit is limited to 30 percent of tax liability up to HUF 50,000 (approximately EUR 200) or HUF 100,000 (EUR 400) for "prominently" public benefit organizations.

The remaining countries permit deductions for individuals, generally on the same conditions as for legal entities, except that the limitations on the amount of the deduction may differ. Individual deductions in some cases are permitted up to a higher percentage of taxable income (e.g., Estonia – 5 percent; Czech Republic, Slovakia – 10 percent).

62 As this Survey went to print, authorities were considering an administrative direction that would limit the availability of the deduction to PBOs.

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3. "1% Laws"

In 1996, Hungary enacted a unique "tax designation" law that permits taxpayers to designate 1 percent of taxes paid to be turned over to civil sector organizations, and an additional one percent to be paid to churches, provided that each of the two designated amounts is at least 100 HUF. In 2001, this law resulted in $25 million USD worth of 1% designations by 1.4 million taxpayer's.

In the past three years, three other countries have followed Hungary's lead and enacted 1% type laws. Slovakia enacted a similar law, which went into effect January 1, 2002. Slovakia's law includes a provision permitting legal entities as well as individuals to designate 1% of their taxes to be distributed to a qualifying NGO. Lithuania recently enacted a law that contains a provision, allowing for a 2 percent designation.[63] In April 2003, Poland adopted a 1% provision – under this new provision, an individual taxpayer's tax may be reduced by a payment to a public benefit organization up to 1% of the taxpayers income for that fiscal year.

63 When Estonia eliminated the tax on corporate income, it could no longer limit the amount of tax-benefited corporate contributions by reference to a percentage of taxable income. It therefore selected another means of imposing a limit. Alternatively, contribution may be up to 10% of profits for the last financial year of a taxpayer dissolved as of January 1.

III. ANALYSIS OF AREAS FOR TAX LAW REFORM

Perhaps the greatest challenge currently facing the NGO sector in Central and Eastern Europe is assuring the sector's financial sustainability. The tax laws affecting NGOs can play an important role in promoting financial sustainability, by among other things, providing for tax exemptions and creating incentives for private philanthropy. As the foregoing summary of the survey results indicates, despite some progress, much work remains to be done if the tax laws in a number of countries in the region are to promote a liberal fiscal enabling environment for the sector.

Two factors suggest that the countries of the region for the most part are ready to confront reform of their tax laws and regulations with the aim of improving the financial sustainability of civil society. The first is that most countries in the region over the past decade have undertaken reform of the framework laws governing foundations, associations, and other forms of NGOs.[64] Improvement of the basic legal framework is an important preliminary step, because, among other things, such legislation defines the basic forms of organization, as well as which organizations will be considered public benefit organizations generally accorded greater tax benefits. Those countries that have not yet completed reform of the basic legal framework for the establishment of NGOs – e.g., Serbia – are also among the countries in the region with the weakest tax incentives for the NGO sector. These countries will likely need to make concerted efforts to improve their laws governing NGOs before they can engage in meaningful reform of the tax laws affecting NGOs. Most of the countries of the region, however, having already addressed basic framework legislation, stand ready to address tax issues.

The second factor is that continued growth of the NGO sector in the region is likely to be impeded without expansion and diversification of funding for NGOs. While the not-for-profit sector in Central and Eastern Europe remains small by international standards, it has grown from relative insignificance to a modest economic force in those countries that have been studied to date.[65] If this trend is to continue in all countries in the region, NGO sectors must build diverse funding bases by, among other things, developing permissible sources of fee-based revenue and promoting private philanthropy. Appropriate tax incentives can assist in this endeavor

64 However, at the time that it adopted the 2% law, Lithuania abolished its tax deductions for individual contributions.

65 Indeed, some countries, *e.g.,* Hungary, have also undertaken significant reforms of their tax laws governing NGOs.

by reducing the tax burden associated with certain sources of NGO income and by creating benefits for charitable giving.

The following are areas in which reform of tax laws in countries in the region would contribute to a better enabling environment for NGOs.

• *Tax exemptions for income earned from business activities.* In most Central and Eastern European countries, indigenous philanthropy has not developed to the point where NGOs can rely on contributions raised either from private grantmakers or from public fundraising efforts to finance their activities. The ability of such organizations, and particularly public benefit organizations, to raise money through business activities designed to support their not-for-profit activities is therefore critical to their viability. The importance of income from economic activities to the support of a viable NGO sector is demonstrated by research showing that on average, in four countries surveyed, private fees and charges make up 46.1 percent of NGO revenue.[66] Private fees as a source of revenue range from a low of less than 29 percent (Romania) to 47 percent (Czech Republic) and 55 percent (Hungary and Slovakia).[67] Significantly, three of the countries examined not only allow NGOs to engage in economic activities, but also provide for exemptions or reductions in income or profits tax for at least some income earned from such activities. This evidence that economic activities are a valuable and needed source of financial support for NGOs suggests that not only permitting, but also encouraging, economic activities by NGOs is critical to the development of a financially sustainable not-for-profit sector.

Macedonia is the only country that still does not permit NGOs to engage directly in business activities for any reason. Macedonia requires NGOs to form separate business subsidiaries to conduct any income-generating activities. This law may create unnecessary burdens for NGOs seeking to raise funds to support their not-for-profit activities. Not only is the law an obstacle to financial sustainability, but compliance problems. For example, it is ambiguous and creates is not yet clear how broadly the 1998 law imposing the prohibition on direct economic activity should be interpreted. Thus, it is difficult to answer questions such as whether an NGO must form a business subsidiary to conduct even *de minimus* income-generating activities, such as one-time fundraising events. Countries with broad prohibitions on economic activities frequently do not have any means of monitoring those economic activities that NGOs do conduct, leaving the sector without appropriate oversight. Macedonia is now considering changes to its framework and tax laws that would permit NGOs to conduct economic activities, and would exempt at least some part of the income from tax.

66 Lester M. Salamon et al., *Global Civil Society: An Overview,* Johns Hopkins Center for Civil Society Studies (2003).

67 Ibid. p. 11.

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Moreover, of the countries that do permit NGOs to engage in economic activities, three – Albania, Bulgaria, and Slovenia – and the Republic of Srpska tax the income earned from those activities in full. This practice does not create incentives for NGO financial sustainability. Bulgaria recently has signaled its intention to create tax preferences for economic activities public benefit NGOs in its new NGO law.

Laws permitting NGOs to engage in economic activities and creating appropriate tax incentives must of course contain some limitations to ensure that NGOs are not formed primarily to conduct business. Unfortunately, in many countries in the region, there have been abuses involving businesses that have registered as NGOs in order to gain tax preferences.[68] Preventing such abuses is certainly an important consideration. However, it is not necessary to deny NGOs either the ability to conduct economic activities entirely or to tax benefits for all income earned from such activities in order to curb abusive business practices. These problems can be dealt with instead by limiting the availability of a tax exemption for profits earned from economic activities to those NGOs that meet an appropriate test. As discussed in section II, a number of countries in the region have adopted such tests, and provide a variety of models that can be used in the region.

• *Tax incentives for donations.* The countries in the region for the most part permit tax deductions to individuals and businesses that make donations to NGOs. However, in Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Romania, and Serbia, there are no tax incentives for individual donations. Moreover, in all cases, the law limits the amount of the deduction to a percentage of the taxpayer's taxable income or tax base. These limitations are for the most part relatively low, and, particularly with respect to individual donations, countries could create additional incentives for donations by raising the permissible amount of the deduction. Hungary, for example, permits tax credits for individual donations only up to approximately EUR 200 or EUR 400, depending on the type of donee organization. In a sophisticated economy, such limits provide no real incentives for individual philanthropy. Moreover, individual philanthropy can play an important role in rooting NGOs within their communities; when NGOs solicit even small donations from individuals they may build better connections with the communities that they serve. Tax incentives for individual philanthropy therefore can help build these important connections. Consideration of other innovative means of financing the NGO sector, such as Hungary's tax designation law, also should be explored.

• *Tax incentives for investments.* Seven of the fifteen countries surveyed – Albania, Bulgaria, the Czech Republic, Latvia, Macedonia, Slovakia, and Slovenia– treat al-

68 www. jhu.edu/~cnp/research.html [October 18, 2000]. The Johns Hopkins Comparative Nonprofit Sector Project, which conducted this research, provides updated information for the countries subject to the survey on its website. The authors attribute the NGO sector's revenue structure in these countries to the predominance of NGOs in fee-dominant fields such as culture and recreation.

most all income from passive investments, such as interest on bank accounts, and dividends, as taxable. Others countries have fairly limited exemptions for passive investment income. Providing expanded exemptions for such income would create a greater incentive to NGOs to invest their assets so as to increase earnings to support their activities.

Two issues deserve particular attention. Exempting the passive investment income of at least public benefit organizations is clearly in accord with international good practice. The tax treatment of passive investment income for mutual benefit organizations, however, presents more complicated issues. Both public benefit and mutual benefit organizations are subject to the nondistribution constraint. Public benefit organizations are also prohibited from distributing their assets upon termination. Instead, most laws require that when a public benefit organization terminates, it must distribute any assets remaining after payment of its debts to another public benefit organization with a similar purpose.[69] Mutual benefit organizations are not prohibited from distributing assets to their members upon termination; since the organization is formed for the benefit of the members, it is considered reasonable to distribute assets earned by use of fees the members paid and efforts they contributed back to the membership. So, for example, if an association of music enthusiasts used fees to buy a piano for use of the members, upon termination, many laws would allow the proceeds from sale of the piano to be distributed back to the members. This creates a potential problem when applied to passive investment income, however, particularly if that income is tax exempt. An investment club could invest funds contributed by the members, accumulate substantial profits, and then distribute the profits to the members upon termination. If such an organization received a tax exemption for its investment earnings, it would be little more than a tax-subsidized mutual fund, an obvious abuse. Laws granting tax exemptions for passive investment income need to limit the exemption accordingly.

A second issue relates to the creation of appropriate incentives for the establishment of endowments. The countries in the region might consider enactment of laws containing special incentives for the creation of endowments (*e.g.,* by providing a special tax credit for such donations), as well as tax exemptions for investment income and incentives for charitable giving (see above). In many countries in the region, indigenous philanthropy has not yet developed to the point where it could be used to create sizable endowments such as those of the large foundations. However, smaller scale endowed organizations, such as community foundations or family foundations, might well be achievable, and could be used to create an additional source of income to sustain NGOs. As the sector matures across the region, it is reasonable to expect that NGOs will expand their use of investments to support their

69 *See* Muller, *supra* note 41, p. 25.

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activities. It may be desirable, in connection with legal reform of the tax laws governing passive investment income, to include provisions restricting unlimited accumulation of earnings, and ensuring appropriate management of endowed funds, by, among other things, setting fiduciary standards for fund managers.

• *VAT.* The laws regarding application of VAT and similar taxes to NGOs contain a patchwork of exemptions, reduced rates, and exclusions from the VAT system. Most countries exempt certain goods and services, employing a list of exempt transactions that is often quite long, with a variety of different types of items. These laws, at least with respect to NGOs, could be made simpler and more effective by adopting a uniform approach applicable to a greater number of NGO transactions. Much can be gained by looking to the harmonization of value added tax in the European Union and by attempting to develop systems in accord with the EU system; this is particularly important for accession countries.[70]

• *Expanding tax exemptions to cover mutual benefit as well as public benefit NGOs.* As noted, a number of countries in the region either limit the availability of tax exemptions to public benefit organizations, or provide very limited categories of exemptions. While mutual benefit organizations do not necessarily serve the public interest in the same sense as do public benefit organizations, they do serve the important function of providing an outlet for a wide variety of citizen interests and are, as a result, indispensable participants in sustaining civil society. There is thus a strong argument in favor of encouraging the creation of such organizations through tax exemptions.

70 *See, e.g.,* Bulgaria's Law on Legal Persons with Non-Profit Purposes, Art. 44, which provides that "[a]ny property remaining after the satisfaction of creditors shall be passed by a court decision to a legal person with non-profit purposes designated for public benefit activities with the same or similar purposes . . .," or, if the property is not transferred in accordance with this provision, to the municipality where the organization had its seat.

71 Harmonization of the VAT tax base is governed in the EU member states by the EC 6th VAT Directive (Sixth Council Directive of 17 May 1977 on the harmonization of legislation of Member States concerning turnover taxes (77/388/EEC), O.J. No. L 145 of 13 June 1977). Those states seeking admission to the EU will be required to adapt their VAT law as necessary to comply with the 6th Directive. The law in Article 13 provides for certain exemptions from VAT for public interest activities, including for the following services which NGOs frequently undertake: hospital and medical care; welfare and social security; protection of children; education; sport; culture; fund-raising; and transport services for sick or injured persons. The EC 6th VAT Directive allows individual states limited discretion to grant relief from VAT to NGOs. It would be possible for states to grant relief indirectly (e.g., through public expenditure by making compensatory grants or increasing existing grants to NGOs) without breaching EC law, but there is no general provision in the laws that would allow a member state to grant broad-based relief in the form of a direct reduction of the tax rate or the tax base other than as part of the existing framework of relief set forth in the 6th Directive. Within that framework, there are two ways for states to reduce the tax burden: (1) reducing the rate of VAT applicable to goods and services purchased by NGOs; and (2) taxing goods and services supplied by NGOs to their beneficiaries at a rate that is substantially below the standard VAT rate. The EC has decided as a matter of policy that in the interests of completing an internal common market, member states should no longer be allowed to apply zero rates except to the extent currently permitted under the terms of a specific derogation granted to a particular state.

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• *Transparency and Accountability Rules.* The extension of additional tax benefits to NGOs will inevitably require consideration of whether NGOs receiving the benefits are sufficiently accountable for their use of these benefits. The countries of the region will needs to develop reporting systems that appropriately balance the need of the government and the public for accountability with sensitivity to the burdens such systems may place on NGOs.

IV. CONCLUSION

The countries of Central and Eastern Europe find themselves at an important juncture with respect to improving the enabling environment for NGOs by providing tax incentives to encourage the expansion and diversification of the funding base for the NGO sector. The information summarized above depicts the current status of tax legislation in the region, and provides a comparative framework for considering the reform measures that could be implemented. It can be expected that targeted reform of the tax laws in a number of countries in the region will continue the significant progress that has been made over the past decade in advancing the development of the legal enabling environment for civil society.

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EXHIBITS

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ISSUES TO CONSIDER

A. INCOME TAX

1. What types of organizations or entities are partially or wholly exempt from the income tax? Indicate any special conditions or limitations (e.g., exempt status might be available only if the entity does not engage in political activities or in unrelated business activities).

2. What types of income are wholly or partially exempt (e.g., membership dues, passive (investment) income)? Indicate any special conditions or limitations (e.g., exemption only above or below a specified amount).

3. Must an organization receive an advance ruling from an agency of the government in order to enjoy tax benefits? (In Austria, for example, no rulings are granted. In Guam only known charities are given advance rulings, while others must apply post hoc every year.) If there is a ruling system, please describe it.

4. Is investment income subject to taxation? How is investment income defined? Are there limits on the kinds of investments that may be made (e.g., in South Africa a foundation is exempt only if it invests in licensed investment funds, listed securities, or other investment vehicles approved by the Tax Commissioner)? Are particular kinds of business activities not allowed (e.g., investments in real estate or speculative investments)?

5. May an organization engage in economic or business activities? If the distinction is drawn between related and unrelated income, how is the line between them determined in practice? At what point, if any, does income from business activities become taxable? (For example, in Hungary the exemption used to extend to any business income that exceeds the lesser of 10% of total income or 10,000 forints - now the rule is a bit more complex.) Does the presence of economic activity income make other income taxable (e.g., does it result in loss of exemption)?

6. Are there minimum distribution rules (e.g., in the US private foundations must distribute at least 5% of their income each year)? Do such rules apply to all organizations or just specific types (as in the US)? May a tax exempt organization make unlimited accumulations (e.g., in Germany income can ordinarily only be accumu-

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lated for one year, but there are special rules that apply to certain accumulations; in South Africa 75% of income must be disbursed by the year after it is received)?

7. Are tax benefits for charitable contributions allowed? What type of benefit (deduction, credit, or rebate)? To what types of organizations can tax benefited contributions be made (e.g., contributions are not deductible in England if made to an organization that engages in partisan politics)? If the determination of tax benefited status is not set out in the law, how is the determination of status made (in Nigeria, for example, deductible contributions may be made to a list of organizations stated in a schedule to the Companies Income Tax Act)? How is qualification for these benefits determined? Are there any limits on the amount of benefit allowed for either corporations or individuals (e.g., in Argentina deductions are allowed only up to 5% of income of both individuals and companies)? Are carryforwards of unused charitable deductions allowed (e.g., in Canada unused deductions can be carried forward for 5 years)?

B. CUSTOMS DUTIES

1. Are certain items exempt from customs duty on import? (E.g., humanitarian relief.) Does the law specify categories of exemption or are they specified in a schedule, regulations, or rules?

2. Are imports by certain types of organizations exempt (e.g., imports by charities).

3. What are the procedures for claiming the exemption(s)? (E.g., show exemption certificate at time of importation or pay duties and seek rebate.)

4. Are there any rules to prevent abuse through resale? (E.g., if exempt goods are sold or given away within three years of importation, the buyer or recipient must pay duty.)

C. VAT (OR GST, OR OTHER SIMILAR TAX)

1. Are there exemptions from VAT for specific kinds of persons (based on type of activities, not on amount of turnover - in other words, are certain organizations that do not engage in economic activities not considered to be taxable persons)?

2. May persons not defined as taxable persons elect to be in the VAT system?

3. Are there exemptions from VAT for specific outputs (good and services)? If so, what categories of goods and services are exempt?

4. Are certain good and services zero-rated or given lower rates? If so, which ones?

5. What are the applicable VAT rates?

D. GIFT AND ESTATE TAXES.

1. Are there exemptions from the gift, estate, or inheritance taxes for gifts to or inheritances by certain kinds of organizations (e.g., in Bolivia all gifts to or inheritances by charitable organizations are exempt)?

2. Are there any restrictions on the exemptions (e.g., only up to a specified amount or percentage)?

E. TAXES ON REAL ESTATE.

1. Are any nonprofit organizations exempt from real estate taxes, or do they receive lower rates or other tax preferences (e.g., religious or educational institution)?

2. Are there any limitations or restrictions (e.g., exemption only up to a specified amount or percentage)?

3. Are any payments in lieu of taxes (PILOTs) or services in lieu of taxes (SILOTs) required from exempt organizations?

F. MISCELLANEOUS

1. Are there any other kinds of tax exemptions, benefits or preferences for nonprofit organizations (e.g., exemption from employment taxes, business franchise taxes, use taxes, etc.)?

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