This document has been provided by the International Center for Not-for-Profit Law (ICNL).

ICNL is the leading source for information on the legal environment for civil society and public participation. Since 1992, ICNL has served as a resource to civil society leaders, government officials, and the donor community in over 90 countries.

Visit ICNL's **Online Library** at
http://www.icnl.org/knowledge/library/index.php
for further resources and research from countries all over the world.

PUBLIC BENEFIT STATUS AND NOT-FOR-PROFIT ORGANIZATIONS

Prepared by the International Center for Not-for-Profit Law

Regulating Civil Society Conference

Budapest, Hungary -- May, 1996

I. Introduction

The recent development and growth of civil society in Central and Eastern Europe (CEE) and the Newly Independent States of the Former Soviet Union (NIS) has necessitated re-evaluation and revision of the legal framework which structures and regulates the not-for-profit/voluntary sector. A rapid increase in the number of not-for-profit organizations (NPOs), predominantly associations and foundations, has outpaced legislative and administrative reform. Consequently, the legal/administrative framework has become a constraint upon growth of the sector. This is occurring at a crucial time, when citizens must learn new patterns of participatory behavior, when pressing social needs require collective responses, and when civil society must contribute to the strengthening of democratic institutions. Despite these important duties, the daily reality for most NPOs, be they local clubs or national organizations, involves dealing with registration requirements, complicated tax regulations, ambiguous administrative mechanisms, and difficult organizational issues (often in the face of public indifference and funding shortages). In an effort to create and implement a legal framework which adequately addresses these issues, legislatures and governments have been enacting numerous new laws, entering into what is for them essentially uncharted territory. This is no small challenge, particularly when combined with the need to establish democratic governance and free market economies after decades of Socialism.

This paper will examine the concept of "public benefit" status for NPOs, in an attempt to provide practical advice for legislators and regulators of not-for-profit activity, as well as lawyers, academics, and other professionals involved with the sector. 1 Although this topic currently has particular importance in the countries of Central and Eastern Europe (CEE) and the Newly Independent States of the former Soviet Union (NIS), it is relevant wherever there are laws and regulations covering the not-for-profit sector. 2

Although it is widely accepted that public benefit organizations (PBOs) deserve either direct or indirect governmental support, the difficulty of translating this principle into law and successfully implementing it confronts legislatures and governmental officials around the world. Accordingly, a number of paradigms for the parameters and significance of public benefit status exist. This paper begins with an exploration of the historical and theoretical development of public benefit organizations, highlighting their important role in society. This will be followed by

analysis of the prerequisites for and privileges resulting from public benefit status, focusing upon accountability and taxation. The balance between responsibilities of and preferences for NPOs will emerge as a constant theme. Comparative patterns for implementing these principles will then be analyzed, along with the rationale for different approaches, with emphasis upon the decision making-processes involved. Finally, current trends and patterns relating to the categorization and regulation of PBOs, as well as difficult conceptual issues, will be considered.

Before beginning, it is necessary to point out that no two countries in the world handle the regulation of NPOs, or the so-called third sector of society, in an identical manner. This is true despite similarities in other aspects of legal systems, and common historical antecedents. Indeed, there are few calls for uniform legislation in this field. Relevant international agreements, such as the Universal Declaration of Human Rights, the International Covenant on Civil and Political Rights, and the European Convention for the Protection of Human Rights and Fundamental Freedoms, do not go much beyond establishing basic principles such as the rights to free speech and free association (which are generally although not exclusively granted to individuals rather than legal persons). The Convention on the Recognition of the Legal Personality of International Non-Governmental Organizations is concerned for the most part with the recognition of legal status for operational purposes. The European Union is working on an agreement to create a "single market" for certain NPOs. However, this is a rather modest step towards bridging large differences concerning matters ranging from the meaning of charity to the establishment and operation of foundations. Interestingly, these differences do not exist exclusively between common law and civil law countries. Often, there is great variety concerning the structure of the not-for-profit sector between countries applying otherwise similar legal traditions.

Under these circumstances, it is clear that each country maintains the right to determine the details of public benefit status in accordance with its customs, legal structure, and social reality. However, despite diversity concerning these details, there is general consensus that a flourishing not-for-profit sector is both necessary for and indispensable to pluralist society and democratic governance.

II. Public Benefit Organizations and Civil Society

A. Historical Background

Both principal legal systems of the world -- the civil law and the common law -- recognize the value of organizations which are created by citizens and/or operate in the interest of the public.3 Because PBOs strive to fulfill educational, cultural, social, physical, and spiritual needs of the citizens and of society, often supplementing the functions of the state itself, governments in turn grant these organizations support through various means, including tax preferences.4 This

lost revenue serves as an indirect governmental subsidy, which helps PBOs to pursue and realize their objectives.

The common law system allows almost any legal organization which operates in the interest of the public to qualify as a PBO for tax purposes. The civil law system usually requires that NPOs fit into one of two distinct categories: foundations and associations. Despite different approaches to the forms of legal personality, both systems consider the purposes of an NPO when answering the essential question, namely whether the organization serves the public benefit sufficiently to merit preferential tax treatment, either directly or for individual contributors. 5

Common Law. Analysis of the codification of the common law system of charity usually commences with the English Statute of Charitable Uses, passed in 1601 under the reign of Queen Elizabeth I. Its twofold purpose was to enumerate charitable causes and eliminate abuse. The notion of public benefit was for the first time formally expanded beyond the relief of poverty, to include care of the sick, the training of apprentices, the building of bridges, the maintenance of roads, and other related beneficial purposes. The sovereign clearly wanted to encourage wealthy citizens to contribute to societal causes, and avoid undue reliance upon controversial ecclesiastical trusts. Accordingly, the concept of public benefit was to be more broadly construed. One of the principal historical mechanisms utilized to achieve this purpose and provide incentives to the populace has been the charitable trust, an equitable convention which separates the ownership and use of property.

The common law system, perhaps in part due to its long and complicated historical development, shows more concern for the purposes than the form of organizations. However, a precise definition of charitable purpose has proven elusive. English case law clearly reflects the difficulty judges encountered in delineating and applying this concept.6 Serious questions remained until 1950, when the Nathan Commission proclaimed the need to avoid impractical definitions and leave the concept "flexible and responsive to changes in the structure of society."7 However, England applies a narrower view than certain other common law countries, excluding the promotion of human rights, and mandating precise statements of purpose. 8

Despite its roots in the English common law, the American system is characterized by a marked expansion in the number of accepted public benefit purposes. In large measure this is due to the powers exercised by the judiciary, along with American social traditions. 9 While registration and some regulation of NPOs in the United States occurs at the state level, responsibility for the determination of public benefit status for purposes of federal taxation lies with the United States Internal Revenue Service. In the 1950s and 1960s, the United States Congress defined public benefit or charitable organizations by first distinguishing public charities from private foundations, and then separating the

latter into operating and the more traditional grant-making foundations. 10 Both the extent of regulation and the tax benefits conferred depend upon these distinctions.

Federal legislation in the United States lists eight categories considered to be charitable. According to section 501(c)(3) of the United States Internal Revenue Code of 1986, as amended, organizations generally exempt from paying federal income tax include those dedicated to religious, charitable, scientific, testing for public safety, literacy, or educational purposes, to promote amateur sports, and for the prevention of cruelty to children or animals. Each of these categories has been extensively developed through additional United States Treasury Regulations and interpretative legal rulings. 11

Common law has followed the British flag around the world. Therefore, many of the above principles relating to charitable activity apply in current and former members of the British Commonwealth. Interestingly, some countries which were previously colonies, such as India, continue to apply laws and procedures which have long since been superseded in England itself.

Civil Law. Civil law countries generally recognize two legal forms for NPOs: associations and foundations. 12 Associations, which are derived from the Roman principle of universitas personarum, consist of natural persons engaged in common activity. Foundations, which derive from the Roman principle of universitas rerum, consist of property (which essentially loses its private characteristics) devoted to a particular purpose. The existence of foundations in numerous European countries since the fifth century BC demonstrates that this form of philanthropic organization is a natural component of civil society. 14 For example, the garden of Theophrast, later Plato’s Academy, was dedicated to the use of his students for a period of 800 years. 14 European associations also have ancient roots, in church movements, and various secular organizations such as Roman colleges of craftsmen, guilds, mutual assistance societies, cooperatives, and unions. 15

Civil law has been markedly affected by the development of comprehensive codes, often tracing their roots to the works of Justinian in the sixth century. The French Civil Code of 1804 is perhaps best known and most influential, but in many countries the German Civil Code of 1896 and others are also valued. In contrast to Anglo-American practice, the French system sees foundations as standing between the individual and the state, and treats them less favorably. For example, the perpetuation of uses after natural death (mort main) is prohibited because it is seen to interfere with rights of inheritance. Further, "la vie associative" was not given formal protection until the twentieth century. While the French Code Civil and this model of civil society have been studied and borrowed both on the continent and in French colonial territories around the world, the diversity of practice even within continental Europe is noteworthy. For example, foundations flourish in the Netherlands, and are often related to political

parties in Germany. In some countries, such as Belgium and Poland, they are restricted to public purposes, while in many others they are not (see below).

Today, most civil law countries extend tax preferences to both foundations and associations. Traditionally, though, the civil law recognizes foundations to be the form of organization designed to work in the interest of the public at large. 16 This distinction is based upon the prevailing idea that associations are mutual benefit organizations (MBOs) where individuals combine to serve their own interests, whereas foundations involve the dedication of property (patrimony) to advance a specific purpose, generally of public utility, and traditionally by means of awarding grants. However, in many countries such as England, France, and Slovenia, the law specifically authorizes associations which act in the public interest. Further, not all civil law countries require foundations to serve the public benefit. Denmark, Greece, Italy, Holland, Germany, and Switzerland permit foundations to serve private purposes. 17 Germany recognizes private foundations, which are primarily utilized to promote family interests. When foundations are permitted to serve private interests, then tax preferences are contingent upon the actual purposes of the foundation, rather than whether it successfully meets the requirements for a specific legal form.

B. The Significance of Public Benefit Status--Taxation Issues

There are many privileges which may be extended to PBOs, but often the primary importance of obtaining public benefit status lies in the tax treatment which an organization then receives from the authorities. In general, the legal framework in most countries does not make the *capacity* of NPOs to act dependent upon having public benefit status. There are some exceptions. For example, in countries which have a special legal form for NPOs serving the public interest, rights and responsibilities obviously depend upon fulfillment of the appropriate criteria. In the United States, an ordinary trust not devoted to public benefit is governed by the rule against perpetuities, and has a limited duration beyond the lifetime of the beneficiary. On the other hand, a charitable trust has no definitive termination date, other than that which may be specified in its founding documents. However, even in such cases, failure to qualify for public benefit status should not preclude the NPO from obtaining legal personality under other applicable statutes. Thus, one of the primary advantages of obtaining public benefit status for an NPO remains the fiscal and tax treatment that results.

For this reason, the core treatment of the public benefit issue can generally be found in tax policies and tax codes. As a consequence, public benefit status is often evaluated and supervised by different governmental bodies than issues such as registration and governance. Further, there can be a divergence in

legislative responsibility, particularly when a committee system is operative. Finally, there can also be differences in dispute resolution systems, which may be primarily administrative, judicial, or even vest jurisdiction with special quasi-governmental agencies such as the Charity Commission of England and Wales.

In any event, the determination of public benefit status can affect the disposition of large sums of money. A foundation required to pay income tax on its endowment might not be able to accomplish its statutory purposes, and an association required to pay taxes on donations in kind may be effectively precluded from accepting them. Thus, tax policy constitutes a collective decision concerning the types of organizations which merit support, a redistribution of the public purse, a message to natural and legal persons concerning social policy, and a guide to the actions of specific NPOs. Enforcement policies exercise similar roles. Indeed, tax policy may spell the difference between financial viability and insolvency for an NPO, and can severely affect development of the entire sector. This point is crucial for countries in a state of transition.

In certain countries, the tax status of an organization depends upon its classification under the not-for-profit laws. For example, in Belgium successful registration as a foundation automatically results in tax exemption. 18 Under such circumstances, the authorities may have an increased right and/or obligation to the public to scrutinize an organization during the registration process. In other countries, registration is not directly related to taxation. In the United States, federal tax status is determined independently from state registration. In Canada, tax authorities also determine public benefit status, although the provinces retain significant rights. 19

Several types of favorable tax treatment exist for not-for-profit organizations, including exemptions from income and profit taxes, property taxes, transfer taxes, excise taxes, value added taxes, and sales taxes. 20 Favorable treatment can extend to local or regional as well as national taxes. In addition to direct tax exemptions, government financial support can be granted indirectly by permitting contributors to claim a tax deduction or exemption. Whether this is in the form of a deduction from income or a credit against tax liability, particularly if tax rates are progressive, can determine the incentives provided to different segments of society. Rules may distinguish between individual and corporate donors, or monetary contributions and those in kind.

C. The Significance of Public Benefit Status--Public Accountability

Organizations which are deemed to act in furtherance of the public interest, and which receive preferential tax treatment from governmental authorities, are generally required to demonstrate their eligibility therefor. The authorities have a legitimate interest in ensuring that NPOs which claim to serve the public actually do so. Additionally, they have a responsibility to make sure that tax preferences

are not wrongfully claimed or used. In short, public benefit status is a privilege, not a right. It must be sought and justified, and it entails reciprocal obligations.

Different countries, naturally, have diverse requirements for obtaining and maintaining public benefit status, and the ensuing tax privileges. Because of differences in management structure, and the need to recognize the wishes of the founders, there may be greater scrutiny of foundations. 21 Nonetheless, such requirements can be summed up in the concept of accountability. MBOs have a responsibility to their members, and to the public at least as far as compliance with the law. However, PBOs have the society at large as their constituents. Accordingly, they must submit to the mechanisms which the society establishes to qualify for this status.

Although the means of exercising public accountability vary, typical provisions include tax returns (even if the NPO is tax exempt), and annual reports to the ministry or agency with oversight responsibility (and perhaps also significant contributors).22 In the United States, the Internal Revenue Code requires most exempt organizations to file annual returns with extensive information concerning the sources and uses of funds, the identity of large donors, the compensation of officers and directors, the nature of business activities, etc. Appropriate disclosure of information also enables the public to exercise oversight responsibilities. This lends crucial credibility to the work of the not-for-profit sector. For this very reason, NPOs in the Czech Republic and Hungary are required to publicize their status in the newspapers. Another attractive option which promotes openness without undue burden or cost to NPOs is requiring that certain information be available to the public at their premises. In any event, the primary goal is enhanced transparency on the part of PBOs.

In spite of the nearly universal requirement for the disclosure of information to promote accountability, there are other mechanisms available to public authorities. For example, in Italy it is necessary to obtain government approval before changing the statutes of a not-for-profit organization receiving preferential tax treatment. Additionally, the law itself serves as an element of accountability. Clarity in the rules and regulations governing NPOs, detailed provisions concerning ethical requirements such as fair dealing and the non-distribution of assets, a clear delineation of the requirements for public benefit status, and fair administration and application of the law, all go a long way towards laying the groundwork for public accountability. 23

D. Public Benefit Status and the Decision-Making Process

One of the key issues associated with public benefit status is the decision-making process. Who makes the determination, and what procedures should be followed? (The criteria for this determination will be discussed in Section III below). While the answer to this question derives in part from historical and socio-cultural experiences, significant changes during the course of the twentieth

century indicate that considerable modification is possible, and that the line between civil law and common law approaches is far from well defined.

Essentially, there are three main models for determining public benefit status. The process can be under the supervision of national tax authorities/an administrative agency, a ministry with a much more diversified portfolio, or a specialized quasi-governmental agency. In each case, the courts can play a number of diverse roles, depending upon whether they are involved in registration or enforcement, or merely serve as an arbiter of disputes. Issues such as the federal or unitary nature of the state, whether there is a parliamentary or presidential system, the general role of the judiciary, and the organization of the taxing authority can play a key role in determining which model applies and how the system is implemented.

The first model is in place in the United States and Canada, where most relevant national tax issues are handled by the Internal Revenue Service and Revenue Canada, respectively. In the United States, this issue is governed by the Internal Revenue Code, regulations issued by the IRS, tax rulings, and case law developed in the court system. Certain organizations are considered per se public charities, such as churches, educational organizations with regular faculty, medical care facilities, and governmental units. In both countries the courts act as the final arbiters of public benefit status, but most decisions are reached by administrative handling of annual tax returns.

The second model, involving ministerial responsibility, is often found in European countries. Approval by the appropriate ministry is required in Belgium, Portugal, Spain, and Denmark. In Luxembourg, the Ministry of Justice must grant qualified status, and then tax benefits result from a formal "arrete grand ducal". In France, foundations must be approved by the Ministry of the Interior, on advice from the Conseil d’Etat, and afterwards they automatically receive tax benefits. In many of the former Socialist countries, such as Romania, Lithuania, and Estonia, it is the Ministry of Finance which is most actively involved in this issue. There are, of course, exceptions in Europe. Presidential Decree is required for foundations in both Italy and Greece. In Ireland, application is made to the Revenue Commissioners. And in the Netherlands, appropriate documents need merely be authenticated and approved by a Notary Public, and then filed (it is not even necessary to notify the government unless annual profits exceed 13,000 Guilders). It is also important to note that in many of the former socialist countries, such as Poland, it is the court system which has been chosen to play a major role in both registration and other matters affecting NPOs.

The third model involves granting powers, such as registration, determination of entitlement to tax benefits, and even enforcement, to a specialized or quasi-governmental agency/organization. The most noteworthy example of this is the Charity Commission of England and Wales. Although the Charity Commission is nominally under the supervision of the Home Secretary, it maintains a great deal

of independence, and is extremely specialized. Great deference is normally given by the courts and the government to its rulings on the qualifications of charitable organizations, and the propriety of their operations. Steps are being taken to introduce such a model in both Bulgaria and Hungary at this time.

Public benefit status can become an issue for decision-makers at various stages in the life cycle of an NPO. For example, there is debate as to whether NPOs should justify their claim for public benefit status at the time of registration (along with meeting the other basic requirements for legal personality). Most NPOs prefer registration to be a simple administrative act, involving no more than verification of compliance with the standard pre-requisites. On the other hand, a few governments in the CEE and NIS countries prefer to carry out a more thorough investigation, and require NPOs to demonstrate eligibility. This can turn registration into a more adversarial process. It can also involve certain institutions in activities beyond the scope of their authority. For example, courts might be charged with investigatory duties. For these reasons, and in order to encourage the formation of NGOs, registration should be kept as simple, procedurally fair, and "user friendly" as possible. Unless public benefit status is inherently related to organizational form, this issue should be determined separately, at a later date, although with retroactive effect.

Evaluation also occurs when the NPO seeks retention and/or renewal of its public benefit status. While many countries require that eligibility be demonstrated on an annual basis, in Belgium and Germany there is a standard three year term before renewal/requalification is necessary. (Almost all European countries mandate an annual filing, although there is often a threshold level of income which triggers the requirement). Finally, the issue can arise when tax authorities exercise their power to revoke public benefit status, in the event of failure to maintain compliance with the appropriate legal requirements. In all of these cases, it is extremely important that there be procedural safeguards, such as the right to appeal to an independent arbiter, in the event of adverse decisions.

Finally, it is necessary to emphasize that there are definite consequences for the legal framework governing NPOs and the status of PBOs, depending upon these choices. To the extent that governmental agencies are specialized, professional, and independent, they are more likely to administer issues related to public benefit status in an impartial manner, which is fair to the not-for-profit sector. Politicized agencies are most likely to administer the law in an arbitrary fashion, depending upon political currents and recent electoral results. Ministries offer existing administrative structures and professional staff with established procedures, but may have an institutional bias or be isolated from current conditions. A quasi-governmental agency, on the other hand, will need to create its own bureaucracy and procedures at additional expense, but may be able to adopt an unbiased approach (with no incentive to maximize tax revenue, for example).

Courts may be the most likely source of apolitical and independent judgments. However, judges have discretion, which could create uncertainty or take the law in unforeseen directions. Additionally, unless the court system is run efficiently, with an eye to precedent based upon accessible records of previous decisions, there is a significant chance of contradictory rulings, particularly in local/regional jurisdictions. Local authorities may be more knowledgeable about NPOs which they oversee, and the prevailing conditions, and thus able to make better informed decisions. On the other hand, national authorities are more likely to apply standard rules, and avoid bias resulting from close personal contact. Yet national authorities may have their own predisposition, towards the major players, to the detriment of the community based organizations which often form the backbone of the NPO sector. It is important that these issues be considered when countries adopt procedures governing not just public benefit status, but a myriad of other issues affecting the not-for-profit sector.

From the above, it is clear that the form of government does not directly determine the handling of public benefit issues. Countries with either parliamentary or presidential systems employ specialized governmental agencies. Countries having parliamentary systems vest responsibility with different ministries, or even lesser authorities (such as the Notary Public in Holland). The Charity Commission model appears to be fully exportable, in spite of historical differences. Courts may play a valuable role in structuring the framework for NPOs, not merely deciding disputes. As a matter of fact, most systems are best described as mixed, incorporating elements of all three models. This is not surprising, since what is at issue is essentially a process. Thus, a certain degree of flexibility must be retained.

E. Theoretical Justification for PBO Tax Preferences

The core element of a not-for-profit organization is the obligation not to distribute profits or benefits to the founders, managers, or other insiders. This restriction, known as non-inurement, or non-distribution, prevents conflicts of interest, and prohibits both direct and indirect allocation of the assets of NPOs to any source other than the proper beneficiaries or statutory purposes. It also requires that after liquidation, all remaining assets be transferred to a NPO with similar purposes, or to the state. 24

Scholars have suggested several theories for granting additional tax preferences to PBOs. First among these is the hypothesis that they deserve support because they actually serve the state and society by providing necessary goods and services that government and/or the private sector cannot or will not provide. Because they complement or supplement obligations of the state, or provide services that are under-supplied due to market failure, PBOs merit subsidies which will enable them to realize their goals. Indeed, PBOs may merit support because they often identify and respond to social needs faster than

governments, harnessing the energy and resources of volunteers, and delivering services more efficiently and directly than governmental bureaucracies.

A second justification for tax incentives points to the general benefit the public receives from maintaining a pluralistic society. Strong civil society both contributes to and results from democratic governance. Indeed, allowing citizens to receive a reduction in taxes in return for contributions to PBOs empowers them to commit resources to valuable social goals. This in turn serves to complement electoral democracy, giving meaning to constitutional rights like freedom of speech and association. However, it should be noted that some countries (like Sweden) deny this form of tax relief, leaving such determinations in the hands of public authorities.

Other theories such as the income measurement theory, the capital subsidy theory, and the donative theory rely on practical considerations to explain society's willingness to automatically provide subsidies to public benefit organizations. Under the income measurement theory, PBOs are granted tax exemptions because most systems of taxation are not designed to accurately determine their true level of taxable income.25 The capital subsidy theory suggests that tax exemptions are needed to compensate PBOs, which serve certain consumers better than for-profit companies, yet have difficulty attracting capital or taking advantage of other preferences granted to investors. 26 The donative theory proposes that PBOs prove their value by attracting a large amount of support from the public, and that the government should follow the lead of the public in the form of additional contributions. 27

III. Patterns for the Determination of Public Benefit Status

Determining which activities undertaken by NPOs constitute a benefit to the public has both philosophical and practical components. Although certain categories of activity are typically recognized as a public service, specific decisions are often difficult. For example, while education is typically recognized as a public benefit, what about schools which are operated privately, or which teach languages for money, or which teach racist philosophy? Public authorities must determine exactly what types of activity should be encouraged, and apply the principles equitably. Parameters need to be set to prevent both over-inclusiveness and under-inclusiveness.

A. Western European Practice

Although it is customary to use the term public benefit in a generic manner, each country defines and applies this concept in its own unique way. Examples of countries which identify a public benefit purpose directly by law include Denmark ("public utility" and "public benevolent purpose"), Germany ("development and well-being of the public at large"), the United Kingdom ("purposes beneficial to the community"), and the United States ("charitable"). 28 Tax laws often, but not

always, set forth the boundaries of and prescribe the treatment for PBOs. Case law has been particularly important in common law countries, such as the United States and Australia. In the United Kingdom, courts have defined the principle of "purposes beneficial to the community."

In many countries there is no precise definition of public benefit in any legislation, but the authorities which register or tax NPOs nonetheless recognize the concept. The following countries fit into this category: France ("humanitarian activities"), Greece ("for the good of people in general"), Ireland ("general benefit to the community"), the Netherlands ("welfare of the public"), Portugal ("purposes contributing to the cultural or general development of the country"), and Spain ("purposes for the public good").

Many countries include a "catch-all" category, which simply mentions "other activities" which are deemed to serve the public benefit. This is an effective means to ensure that enumerated purposes are not interpreted in an overly restrictive manner, and that the concept of public benefit remains flexible over time, in response to changing social conditions. After all, public benefit is a dynamic, not a static concept, and mechanisms to enable its expansion/development are appropriate.

In addition, it is common to enumerate certain specific purposes which are deemed serve the common good. These often include promoting health, education, science, the arts, traditions, culture and the preservation of cultural monuments, relief for the poor and underprivileged, assistance to physically disadvantaged people, children, and the aged, reducing the burdens of government, enhancing knowledge and civic participation, protecting the environment and nature, supporting religion and human values, furthering social welfare, minority rights, and human rights, supporting public works and infrastructure, sports, etc. 29 For example, German tax law includes public health care, general welfare, environmental protection, education, culture, sports, scientific purposes, the support of persons unable to care for themselves, and church and religious purposes. Belgium, without stating any general public benefit purposes, accomplishes a similar result by extending benefits to cultural associations. The enumerated categories demonstrate and define a societal decision to support spiritual, physical, intellectual and cultural needs. 30

Individual countries often include additional categories of public benefit purposes, which result from particular circumstances and cultural traditions/heritage. 31 This is natural, and should be encouraged. On the other hand, individual countries can also exclude certain types of activities. For example, sometimes there are restrictions upon political and legislative activities of NPOs, such as lobbying and campaigning (this is more generally the case in common law countries). 32 Sports is also subject to divergent treatment. Whereas Belgium, France, Germany, and Luxembourg all specifically designate sports as an acceptable public benefit purpose, the United Kingdom specifically precludes

sporting organizations from receiving preferential tax treatment, unless they operate for another permissible purpose (such as helping handicapped people). Religion presents a third example of divergent practice. Although accepted and promoted in many countries, religion is excluded from preferential tax treatment in Australia.

As mentioned previously, common law and civil law countries diverge concerning which types of legal forms are authorized for PBOs. Common law countries often allow several different legal forms to qualify. In Ireland, for example, trusts, companies limited by guarantee, corporations, and unincorporated associations can all qualify. Civil law countries, such as Denmark and France, allow only associations and foundations to qualify for tax benefits. However, certain civil law countries are much less restrictive. In Germany, Italy, and the Netherlands, NPOs such as corporations, partnerships, institutions, and limited liability companies, in addition to traditional foundations and associations, can be formed.

In recognition of the higher level of scrutiny which applies to PBOs, there are sometimes more procedural requirements for the establishment and registration of foundations than associations. Associations (most particularly when they do not aspire to receive public benefit status) can often be created by merely depositing notarized statutes or bylaws with a specified government agency. Foundations or entities seeking preferential tax treatment sometimes need to meet more stringent requirements established by governments and/or ministries. In France, for example, mutual benefit or simple associations can be registered by depositing their statutes with the Prefecture de Police, while both foundations and Associations Reconnues d'Utilité Publique require approval from the Ministry of the Interior, on advice from the Conseil d'Etat. However, as stated previously, it is preferable to separate the process of qualification for public benefit status from the process of registration, unless such status is an inherent characteristic of the organizational form. And further, the requirements for obtaining public benefit status should not be burdensome for the NPO.

There are three general models concerning the timing/procedure for obtaining tax benefits. A priori qualification occurs when tax preferences are automatically conferred upon an NPO which fulfills specified criteria for registration. Accordingly, registration itself is the principle challenge, and the stage at which eligibility must be demonstrated, often pursuant to investigation. This practice is exemplified in France, where a public benefit NPO must first establish its identity and eligibility in order to obtain legal personality. Having done so, it is automatically eligible for tax advantages due to its status.

The second model involves certification independent of and subsequent to registration. In this case, registration is the first step. This is followed by qualification for tax benefits, which may be obligatory or optional. Luxembourg exemplifies the obligatory procedure, since after registration as a public benefit

entity with the Ministry of Justice, the NPO must still obtain an arrete grand ducal to receive tax benefits. Holland follows the voluntary approach, whereby PBOs may but do not need to obtain an advance ruling from Dutch Revenue concerning their qualified status. In the United States, following registration under state law, NPOs obtain tax-exempt status by filing an application with the Internal Revenue Service using Form 1023.

The third model involves scrutiny of the public benefit status of the NPO only during the taxation process itself. In such cases, NPOs must still be established under law, with a valid form and legal purposes. However, scrutiny concerning public benefit status commences with a claim for preferential tax treatment, and there is no procedure for resolving issues relating to tax status until a return is filed with the appropriate authority. Since many countries create mechanisms for determining tax status subsequent to registration but prior to tax filings, this third model is often found in countries in transition which lack fully developed tax procedures.

In all countries of Western Europe, there are well developed and independent mechanisms for resolving disputes between NPOs and the authorities which handle issues ranging from registration to taxation. In both common law and civil law countries, this responsibility ultimately lies with the courts. However, a great variety of preliminary administrative mechanisms is available. And there are also differences concerning the authority and competency of courts. As a general proposition, common law countries are more likely to grant expansive powers to the courts, and rely upon judicial precedents to build a body of applicable case law. In civil law countries, the courts are more specifically charged with resolving particular disputes.

B. Emerging Trends in Central and Eastern Europe

Transition from the state-dominated socialist system has opened many new avenues for NPOs, while at the same time creating needs and challenges which they must meet. The potential roles and activities of PBOs in the CEE countries and the NIS are numerous. In part this is due to the diminished financial and administrative capacity of previously centralized states to meet the social, cultural, educational, environmental, and medical needs of the public. Additionally, the transition process itself has resulted in greatly diminished levels of income and welfare. Thus, social needs are expanding at a time when the state is less able to meet them. Privatization constitutes an entirely new mechanism for transferring these responsibilities. Democratization has also increased the level of opportunity for NPOs, and given them new duties to the body politic. In short, the social and political space now exists for NPOs to play a vital and dynamic role.

On the other hand, the reality facing many NPOs in this region is problematic. Obtaining sufficient funding is a challenge, and thus there is considerable

turnover. The public is often indifferent or disillusioned, unaware of the importance of NPOs, and reluctant to shed passive attitudes and contribute time and resources which are in short supply. Traditions of corporate and other types of philanthropy are not yet well established. Capital resources are very limited, leaving many NPOs dependent upon international sources of funding. Image problems have resulted from the (infrequent but over-publicized) use of NPOs to engage in political and economic activities. Governments are, with some exceptions, not very interested in communicating with the sector. Lobbying skills (as well as others, such as management and fundraising) are only slowly developing. The legal framework for NPOs is not yet firmly in place, in part due to the incredible number of political, economic, and social issues which legislatures face simultaneously. This creates uncertainty, and results in administrative, fiscal, and other disincentives. While there are large numbers of intelligent and motivated individuals, and incredible opportunities, the not-for-profit sector has not yet lived up to its potential.

The legal framework for NPOs in CEE and NIS is a central and critical issue. The post-socialist transitions have unleashed a flurry of legislative activity. Yet the pace of legal change in the region varies greatly. Certain countries, such as Poland, the Czech Republic, Hungary, and Estonia have made considerable progress towards the establishment of a viable legal framework for PBOs. Certain other countries have not moved as quickly.

The incomplete and changing legal framework for the not-for-profit sector in CEE and NIS makes direct comparison of laws difficult. However, some emerging trends, particularly regarding acceptable legal forms for NPOs, are readily identifiable. The basic legal framework for NPOs in this region, both historically and even to a limited extent under socialist governance, has been based on the civil law. Thus, as a general rule, religious organizations, political parties, and trade union movements are subjects of separate legislation, and the principle forms of both PBOs and MBOs are the association and the foundation. However, in many instances, variations upon these basic forms, and even novel legal forms, are being established in order to meet current social, administrative, and other challenges.

A common variation, which exists in Hungary and is proposed in Poland (with disapproval from the sector) is the Public Foundation. In Hungary, Public Foundations secure the continuous provision of certain public tasks, and can be formed by both national and local governments (German lä nder have certain comparable rights). Hungary also has Public Chambers, with self governance and registered membership, which are established by special law (such as the Academy of Science, and certain professional organizations). In Slovakia, Professional Chambers are established by special law, as are Funds, which are essentially the public law equivalent of private law foundations. The Czech Republic has recently passed legislation creating Public Benefit Companies, which may serve as a vehicle to transform state-owned and run institutions into

PBOs (although the absence of a minimum level of endowment may make them an attractive alternative to operating foundations). This is not unlike the Public Benefit Company which exists under Hungarian law, based upon a letter of incorporation, and often governed by the rules applying to Limited Liability Companies. A comparable entity is the subject of proposed legislation in Slovakia. And Russian law includes a related legal form, called the Non-Commercial Organization, as well as other possibilities under the Law on Public Associations (which are not in accordance with standard civil law concepts). Lithuania has passed legislation which establishes Community Organizations, which can be in the form of either foundations or associations, but are limited to Lithuanian natural persons.

To a certain extent, such experimentation with different legal forms is commendable, since it allows for innovative approaches which may better meet social requirements. However, in the absence of systematic implementation and carefully considered policy goals, the result can be increased uncertainty and disarray in the sector, not to mention numerous administrative problems. Particularly when countries find themselves undergoing systemic transformation, legal certainty is of great benefit to the NGO sector and society, even sometimes at the expense of perfection. In Romania, Law 21 of 1924 on Legal Persons was, for inexplicable reasons, not repealed by the socialist government. For five years now, it has been restored and given legal effect, and it is widely considered to create a viable legal framework. However, despite some noteworthy problems (such as outdated language and references to other institutions which no longer exist), the desire for stability has tempered initiatives to pass new legislation, which have only recently accelerated.

As a general proposition, the concept of public benefit status is unevenly developed and applied in CEE and NIS. At the heart of the problem is the fact that taxation systems are being recreated from scratch, particularly in countries which were formerly part of the Soviet Union. However, in certain countries recent legislation simply does not address this concept. For example, the Law on Persons and Families in Bulgaria does not differentiate between PBOs and MBOs (although recent draft laws do introduce this distinction). The same is true for Slovakia. On the other hand, Macedonia does provide tax concessions, in different laws, not specifically aimed at particular organizations but creating categories of public benefit activities. In Poland, income tax exemptions and personal and corporate deductions are permitted when NPOs support scientific, technical, educational, and cultural activities, protection of the environment, social initiatives and charity, protection of public health, rehabilitation of the disabled, and religious causes. Similar categories are recognized in the Czech Republic. Hungary also has a particularly well developed system. Contributions to foundations (although not generally associations) are deductible for both natural and legal persons, if used for qualified activities in the fields of culture, education, religion, social causes, etc. There is a presumption that this is the

case with Public Foundations. In addition, provisions in the laws on value added tax, customs duties, and local taxes also grant preferences to PBOs.

The diversity of examples above shows that there is little tendency towards the harmonization of European laws relating to the particular characteristics of public benefit status. Nonetheless, it is hoped that the countries in transition will be able to study and benefit from the experiences of the countries with more developed legal systems, thereby making intelligent and realistic decisions. However, it is necessary to point out that many CEE countries, such as Poland and Hungary, have long-standing traditions concerning civil society organizations, and that the process of transition itself results from the rupture caused by Soviet expansion.

IV. Critical Issues Concerning the Determination of Public Benefit Status

It is extremely important to understand the historical derivation of public benefit status, the privileges and responsibilities which result, how the determination is made, the various legal forms which are appropriate, etc. However, the laws covering these topics must in the final analysis be applied. While principles can be established in legislation, either ministries or administrative agencies, and ultimately the courts, must evaluate and reach conclusions concerning specific organizations.

Initially, the laws and regulations which govern the not-for-profit sector should clearly set forth the purposes which are acceptable for PBOs. If the parameters are adequately defined, the potential for misinterpretation and/or abuse is minimized. Secondly, the public authorities must implement these laws in a professional, responsible, even-handed, and open manner. Decisions should not be politicized, arbitrary or capricious, and should always be based upon the law and the merits of the case. Employees of the decision-making entity should be familiar with all applicable laws, regulations, and procedures, and should be knowledgeable about the NGO sector. Additionally, they should have the necessary language skills to carry out their functions. NPOs themselves should be encouraged to participate in the process of regulation, by creating umbrella organizations with oversight responsibilities, and by being given opportunities for consultation. Finally, the process must be subject to review by an impartial authority, with sufficient power to correct not only abuses but also simple or administrative errors.

When laws addressing public benefit status list the general categories of activities which qualify, and the responsibility for determining specific parameters is left to some form of administrative agency, it is necessary to develop a body of decisions or applications which will clearly set forth state policy, and serve as a guide to the not-for-profit sector. In spite of the need for certainty, there must be some degree of flexibility in these determinations, to reflect changing social conditions. Because the concept of public benefit is dynamic over time, flexibility should be enhanced by the inclusion of a "catch-all" category.

One of the principle issues raised by this taxonomic approach (enumerating categories of public benefit purposes) is whether there is a rebuttable presumption that activities fitting within one of the established categories should be given preferential tax status. In other words, where does the burden of proof lie? If successful registration as a particular legal entity in and of itself constitutes acknowledgment of public benefit status, then the burden for any subsequent disqualification seems to shift to the authorities, unless of course there is a periodic renewal or evaluation process. If the government keeps a register, the initial responsibility to demonstrate eligibility may fall upon the NPO. Once public benefit status is obtained, however, there should be a presumption in favor of continuity, until and unless revocation is warranted, based upon (preferably annual) monitoring/reporting requirements. In any event, there must be machinery to make case by case decisions in the event that NPOs do not fit precisely within one of the enumerated categories, or if disputes concerning status arise. 33

A crucial theoretical and practical problem results from the fact that the term "public" lacks a clear and precise definition. The expansion of the concept of charity in the common law jurisdictions from relief of poverty to include a series of "worthwhile" activities can in part be traced to a more expansive view of the "public". But it is clear than any given activity, no matter how laudatory its nature, directly benefits only a portion of the public. MBOs may actually serve a larger constituency than PBOs, and both normally benefit no more than a small percentage of the public. In response, it can be argued that it is the nature of the activity, and whether it should ideally be undertaken by government, which is determinative.

A related conceptual problem arises with the distinction between PBOs and MBOs. Even the term "benefit" suffers from some ambiguity. Employees of PBOs still derive some "benefit", if not from the operations of the entity then from its mere existence. Salaries, experience, and personal contacts obtained by individuals working for PBOs could easily be more valuable than what members of a mutual benefit association receive. Additionally, it is quite conceivable that associations which are designed first and foremost to promote the interests of their members might indirectly provide considerable benefits to the public at large. Thus, it is clear that the principles of non-distribution and mutual benefit can be difficult to apply in a large number of instances.

Likewise, it is not always easy to apply the categories of public benefit enumerated in laws or tax provisions. Should these categories be construed expansively or restrictively? Should the formal inclusion of an activity be sufficient, or should there be further scrutiny based upon the specific purposes of an organization? For example, is the promotion of religion sufficient *ex ante*, or should preferable tax treatment depend upon a further showing that the beliefs espoused by the religion are in the interest of the public? Such decisions may be made by the authorities, or there may be a mechanism for the public to challenge

tax preferences. However, the latter process could lead to controversial and ideological battles between opposing interest groups. The definition of public benefit should not depend upon popularity, since by their very nature PBOs, at least initially and directly, serve defined segments of society. In order to prevent shifting public opinion from dictating social policy, the better practice may be to vest authority with the government and the courts to ensure that PBOs fit within the parameters of public policy.

V. Conclusion

The foregoing discussion demonstrates the complicated issues associated with public benefit status, from criteria and procedures for evaluating NPOs to the preferences which result from obtaining this status. Clearly, the issues which arise are political, economic, social, administrative, and fiscal at the same time. While certain countries enjoy a long history of precedents, case law, and established practices, this by no means guarantees conclusive answers to such difficult questions. Other countries which are in the process of reforming their legal systems, while deprived of historical continuity, are uniquely able to consider these issues anew. This creates an opportunity to pass well-crafted laws and implement efficient practices to govern the not-for-profit sector, at least in part based upon the experience of neighbors. In either case, it is clear that a process is at issue, not a search for perfect answers.

In order to create a workable process which both protects the legitimate interests of the state and permits the formation of a viable and flourishing third sector, certain basic principles apply. In the first place, a well constructed legal framework should be established. The laws should be clearly drafted, with participation from the governed, in an open and democratic process, and then made accessible and intelligible to all those concerned. Secondly, the laws should be administered fairly, efficiently, and openly, without conflicts of interest or bias, and once again with consent and participation from the governed. Finally, the process should have built-in procedural safeguards which protect the interests of the governed. This requires the establishment of an independent and impartial authority, to which NPOs can appeal regarding any disputes with governmental authority, be they procedural or substantive. In the final analysis, it is not the particular structure of the system governing public benefit status which is most important. Whether it is the Charity Commission in England and Wales, the Office of the President in Greece, or the Internal Revenue Service in the United States, a consistent and equitable process for handling public benefit issues, based upon the principles enunciated above, is the goal.

---

1. Further development of the meaning and implications of public benefit status was requested during two international conferences on "Regulating Civil Society", which were

organized by the International Center for Not-for-Profit Law in Sinaia, Romania in May of 1994 and Tallinn, Estonia in May of 1995. In addition, conference participants identified two other themes requiring further analysis. They are: 1) the extent to which NPOs should be permitted to engage in political activities, and 2) the extent to which NPOs should be permitted to engage in commercial/economic activities. These topics are addressed in two separate papers.

2. The general term "public benefit" is used throughout this paper to designate those organizations with purposes which serve the public at large, in contrast to those organizations which have private purposes, or which predominantly or exclusively interest and/or benefit their members.
3. The legal system in the socialist countries will not be considered in great detail. While it forms the basis upon which current reforms are being carried out, and is of great historical interest, it does not constitute a viable model for the creation of civil society, and its legal and socio-political influence is therefore limited. However, it is important to note that the socialist countries did recognize a form of civic association, albeit strictly controlled by and subordinated to the state and/or party.
4. As a general principle, both PBOs and MBOs should be exempt from income taxation on money or other items of value received from donors or government agencies, or in the form of membership dues, interest, dividends, and capital gains when same are devoted to the statutory purposes of the organization. However, additional tax preferences such as deductions/credits for donors are generally reserved to PBOs. *See* The Blueprints Project 6 (International Center for Not-for-Profit Law, March 1995) and Sections 24-25 of the Open Society Institute Handbook on Laws for Civic Organizations (prepared by ICNL, 1996).
5. Leon E. Irish & Karla W. Simon, Definition and Boundaries of the Nonprofit Sector: The Role of Law 7 (1995) (on file with author) and the Open Society Institute Handbook on Laws for Civic Organizations, Chapter H.
6. The civil law countries did not face this dilemma, since the traditional definition of charity is limited to care for the sick and relief of poverty, and the courts were not given interpretative powers. *See* Frits W. Hondius, The Law on Foundations: An International Status Report 12 (Strasbourg, 1989) (on file with ICNL).
7. James J. Fishman & Stephen Schwartz, Nonprofit Organizations: Cases and Materials (The Foundation Press, 1995) at 132.
8. For example, the purpose of "peace" has been found not to qualify as a charitable purpose under English law. Frits W. Hondius, The Law on Foundations: An International Status Report at 12, s*upra* note 6.
9. James J. Fishman & Stephen Schwartz, Nonprofit Organizations: Cases and Materials, at 132, *supra* note 7.
10. Id. at 310-311.
11. ICNL, Provisions of the United States Tax Laws Affecting Not-for-profit Organizations 4 (April 1995) (on file with author).
12. In some civil law countries, particularly in Central and Eastern Europe, additional legal forms for NPOs have been created. For example, in the Czech Republic, a law was passed in September of 1995 to create "public benefit companies". These serve as a vehicle to convert certain governmental welfare programs to more "public" control, and remove them from the state sector. *See* Act on Nonprofit Corporations, Czech Republic (effective January 1, 1996) (on file with ICNL). Other countries are considering this model. Hungary has created three additional forms, namely the Public Chamber, the Public Foundation, and the Public Benefit Company.
13. Alain Anciaux *et al*., *The Third Sector in Western Europe, in* Citizens Strengthening Global Civil Society at 238 (McNaughton and Gunn Inc. 1994).
14. Id. at 251.
15. Id. at 240.

16. Id. at 248, 251; Leon E. Irish & Karla W. Simon, Definition and Boundaries of the Nonprofit Sector: The Role of Law at 5, *supra* note 5.
17. Alain Anciaux *et al*., *The Third Sector in Western Europe* at 252, *supra* note 13.
18. *See* Derek Allen, Tax and Giving in Europe: A Guide to the Tax Treatment of Voluntary Bodies in the European Community and of Donations Made to Such Bodies (London: The Directory of Social Change, 1993).
19. Frits W. Hondius, The Law on Foundations: An International Status Report at 21, s*upra* note 6.
20. The Blueprints Project at 12, *supra* note 4, the Open Society Institute Handbook on Laws for Civic Organizations, Chapter H.
21. Alain Anciaux *et al*., *The Third Sector in Western Europe* at 252, *supra* note 13.
22. The Blueprints Project at 11, *supra* note 4.
23. Despite the need to protect the public from fraud or abuse, laws and regulations which make PBOs accountable to the public should not be so burdensome as to make them unable to function successfully. *See* Karla W. Simon, Principles of Regulation for the Not-for-Profit Sector 2, 3 (ICNL, 1994).
24. Open Society Institute Handbook on Laws for Civic Organizations, Section 19.
25. James J. Fishman & Stephen Schwartz, Nonprofit Organizations: Cases and Materials, at 319-324, citing Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Tax*, 85 Yale L.J. 299, 307-316 (1976).
26. James J. Fishman & Stephen Schwartz, Nonprofit Organizations: Cases and Materials, at 326-328 citing Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Tax*, 91 Yale L.J. 54, 72-75 (1981).
27. James J. Fishman & Stephen Schwartz, Nonprofit Organizations: Cases and Materials, at 329-333, citing Mark A. Hall and John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 Ohio St.L.J. 1379, 1381-1389 (1991).
28. For more information on tax treatment within the European Union, *see* Derek Allen, Tax and Giving in Europe: A Guide to the Tax Treatment of Voluntary Bodies in the European Community and of Donations Made to Such Bodies (London: The Directory of Social Change, 1993) which has been heavily relied upon in this section.
29. The Blueprints Project at 6, *supra* note 4.
30. Frits W. Hondius, The Law on Foundations: An International Status Report at 5, s*upra* note 6.
31. Id. *See also* The Blueprints Project at 7, *supra* note 4.
32. The Blueprints Project at 7, *supra* note 4. See also the ICNL Paper concerning Political Activities by NGOs.
33. James J. Fishman & Stephen Schwartz, Nonprofit Organizations: Cases and Materials, at 133.

International Center for Not-for-Profit Law
1511 K St. NW, Suite 723 - Washington, D.C 20005 **Phone:** (202) 624-0766 **Fax:** (202) 624-0767
E-Mail: infoicnl@icnl.org