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**Translation**

**MAECENATA INSTITUTE**
**FOR THIRD SECTOR RESEARCH**

**Bertelsmann Foundation**

*(We need ... in addition to state action ... many citizens with a commitment for social, humanitarian, cultural, and ecological work in the interest of the public good. For this purpose diverse opportunities should be created and obstacles removed. This includes ... the law governing not-for-profit organizations and foundations being designed appropriately. We need donors who promote not-for-profit activities with money or time.*

*From the joint declaration issued by the Federal President Johannes Rau and the three former Federal presidents Roman Herzog, Richard von Weizs cker, and Walter Scheel on September 12, 1999.*

# PROPOSALS FOR REFORM OF THE LAW GOVERNING FOUNDATIONS AND NOT-FOR-PROFIT ORGANIZATIONS

1. The Bertelsmann Foundation and the Maecenata Institute set up an expert commission in December 1998 to study and play a supportive role in regard to the reform of the law governing foundations and/or not-for-profit organizations, which has been advocated for years and which was agreed upon in the coalition agreement of October 1998. This expert commission definitely does not see itself as an interest group representing

foundations and/or not-for-profit organizations but has as its objective the study of issues of fundamental importance to the parliamentary process and the provision of factual arguments regarding them. The commission has held seven colloquia and one public forum up to now. The results are being published on an on-going basis in the form of position papers, presentations, and individual discussions as well as extensive working papers in a binder.* About 100 German and foreign experts with scientific and practical backgrounds have taken part in the consultations.

2. The expert commission has not set itself the goal of submitting a final report endorsed by all of the participants. As well, the commission's work has not yet been concluded. However, the desire to present results and interim results containing specific proposals in a concise form is taken into account below. These proposals will form the basis of a discussion to which the Bertelsmann Foundation and the Maecenata Institute will invite interested parties before the end of the year, after the eighth colloquium.

3. By no means do the proposals contain all of the results of the consultations which have also led to more detailed deliberations with regard to essential issues. They reflect the views of the majority of the participating experts. However, the responsibility for their publication rests solely with the Maecenata Institute and the Bertelsmann Foundation.

4. While in the important civil law sector (in particular Sections 80 - 80 [sic] of the [German] Civil Code) there is a broad consensus in the meantime regarding the principles of the reform, which take into account

the proposals in Number 2, in many cases the bases for development of a reform are lacking in the not-for-profit law sector. It is a definite fact that the present system for taxing corporations oriented towards the public welfare, which is laid down in the tax code and in other regulations, is no longer adequate and, therefore, must be reformed fundamentally, especially in regard to its political objectives, structure, and procedures. A possible model, which not least was developed from comparisons with other foreign models, is presented in Numbers 4 and 5.

**B. GOALS OF THE REFORM**

1. In the parliamentary sector the starting point for the reform was the demand that more incentives for the endowment of foundations be offered. In addition, the discussion revealed a number of fundamental shortcomings in our laws governing foundations and not-for-profit organizations which showed that reform was urgently required. The present law is not only unsystematic and in need of correction in individual cases, it reflects, in particular, a view, which is no longer contemporary, of the necessity of intensive state supervision and of the assignment of charitable action to the state.

2. In view of the fundamental change in the paradigm, the so-called third sector, i.e. essentially not-for-profit organizations, has become the third pillar of society beside the market and the state. Voluntary activity in independent organizations is seen as an important social adhesive, as a basis for the integration and participation of all citizens. Voluntary assumption of responsibility, which is expressed in donations of time in the same way as in donations of large or small endowments, is an indispensable prerequisite for this. For this reason the third sector requires a new statutory framework. Consequently, reform of the law governing foundations and not-for-profit organizations is part of a social policy reform package which is dedicated to strengthening democracy as a way of life and of civil society as an organizational model.

3. The goal of the reform is to strengthen the voluntary sense of responsibility and to encourage the donation of time or property. To this extent a foundation-friendly law is not only of benefit to the well-off but part of attempts to set free the potential of voluntary solidarity.

4. Even in times of extremely tight budgets the reform project must enjoy political priority. This is all the easier since incentives to endow foundations contribute to the permanent dedication of taxed income to public use and, therefore, to the financing of public welfare functions on a voluntary basis. Consequently, minor tax losses resulting from small improvements in the law governing not-for-profit organizations are more than offset.

5. What serves the public welfare should be continuously reconsidered and redefined in accordance with legal and political criteria. It must be possible to provide special support for political decisions on a long-term or temporary basis as objectives which are considered particularly important. At present, such goals are, for example:

- ò combatting unemployment,
- ò promotion of an integrated sustainable development taking into account ecological, social, and cultural aspects (Agenda-21 Process),
- ò civic commitment (e.g. in civic foundations and voluntary agencies),
- ò promotion of innovation,
- ò promotion of culture.

The goal of the reform must also be to develop a differentiated and factually oriented method to assess the public welfare and to develop different levels of tax relief. There is still considerable need for discussion of these goals.

6. Foundations and other corporations oriented towards the public welfare must be included in a policy of deregulation and strengthening of the subsidiarity principle.

7. Recipients of medium and small incomes should also be offered incentives to endow foundations and make charitable donations.

## C. THE PROPOSALS IN DETAIL

### 1. The concept of the foundation

1.1 Foundations originate in accordance with the following provisions through the dedication of property, permanently or for a period of time, to a not-for-profit purpose set down upon the foundation being established (see Number 4).

1.2 Every natural or legal person may endow foundations alone or together with others. Foundations may endow foundations themselves provided their statutes allow this.

1.3 Foundations may be established as

- ò foundations having legal capacity under civil, church, or public law (with their own legal personality),
- ò (trust) foundations not having legal capacity (without their own legal personality),
- ò foundations in the form of corporations (with their own legal personality).

1.4 Private civil law foundations having legal capacity can be established by dedicating property permanently or for a period of time to a purpose for private benefit set down upon the establishment of the foundation. They are distinguished from other foundations by the designation private foundations.

## 2. Reform of the law governing civil law foundations

2.1 Civil law foundations acquire legal capacity through registration in a register (Register of Foundations, Part A) which is managed by the agency responsible for foundations under Land[1] law. Registration requires:

- a statement of the intent of the founder(s);
- preparation of statutes;
- review of the statutes by the registering agency to determine that they conform formally with the regulations. This review shall be carried out within two months at the most.

Where these prerequisites have been met, founders have the right to be registered.

2.2 The founder's intention with regard to the name, residence, assets, purpose, and organization of the foundation are to be set down more precisely in the statutes. In principle, founders are unfettered in stipulating their intentions. The founder alone is responsible for providing the foundation with the means and designing the statutes in such a way that it is a viable entity which can fulfil its purpose. There are no restrictions on the choice of a residence and on the assets with which it is to be provided. However, asset

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1 TranslatorÆs note: Land (LΣnder) = approximately state(s) or province(s).

management, including the safeguarding of ownership rights, must not be the purpose of a foundation if its assets do not serve to directly realize its public-welfare purpose.

2.3 Founders may reserve special institutional right for themselves. In foundations to whose assets numerous founders contribute, also one after another (civic and community foundations), the statutes may also grant future donors institutional rights.

2.4 Civil law foundations are subject to state legal supervision under Land law. This supervision extends to fulfilment of the founder's intention and compliance with the law as well as with the foundation's own statutes. A strict yardstick is to be set with regard to the principle of proportionality in implementing this supervision. There is no supervision of the way in which the foundation carries out its activities.

2.5 The Register of Foundations contains information on the name, residence, assets, purpose or purposes as well as the members of the bodies of the foundation. It can be inspected by anyone.

2.6 Registration in the Register of Foundations entails the obligation of preparing an annual report on the finances and activities of the foundation within a specific time period. The financial report has to provide information on assets and liabilities as well as income and expenses in the reporting year. These reports are to be published. This obligation to publish will be satisfied by the foundation having the reports forwarded to the authorities responsible for the foundation as well as to two agencies who, on their part, are obligated by their statutes, or suitable in

view of their activities, to publish them (e.g. Internet, databanks of German foundations, etc.). An obligation to publish graduated in accordance with the size of the foundation is conceivable.

2.7 Private foundations follow the same process to acquire legal capacity and are also registered in the Register of Foundations (Part A). However, they are subject to state legal supervision only in regard to revisions to their statutes and not to the obligation to publish discussed in 2.6.

## 3. Suggestions for reform of foundations not having legal capacity and foundations in the form of corporations

3.1 Foundations not having legal capacity and foundations in the form of corporations may be registered in the Register of Foundations (Register of Foundations, Part B). Their statutes have to satisfy analogously the requirements set down in 2.2.

3.2 Foundations not having legal capacity and foundations in the form of corporations are not subject to supervision by the authorities responsible for foundations.

3.3 Registered foundations not having legal capacity and foundations in the form of corporations are subject to the obligations to publish set down in 2.6.

## 4. Concept of public welfare

4.1 Public-welfare-oriented corporations (foundations and others) are corporations which promote public spirit,

responsibility, and commitment on the part of citizens with respect to the common good on a voluntary basis, support altruistic objectives, provide services promoting the public welfare or disadvantaged people without the intention of obtaining profits, or support efforts in this sector.

4.2 Public-welfare-oriented activities include the following sectors, in particular:

- culture,
- sport,
- education and research,
- health,
- social services including charitable assistance,
- environmental protection and nature conservation,
- developmental assistance,
- the interests of citizens and consumers,

- ò international understanding,
  church activities.

4.3 Public-welfare-oriented corporations are classified into:

- ò Group A: corporations which are committed to the public welfare in a general sense by their statutes and activities and which do not distribute surpluses from their activities to owners, members, or other persons not serving the public welfare;
- ò Group B: corporations which also carry out in a narrower sense functions whose implementation is important to society and the state;
- ò Group C: corporations which also carry out in an even narrower sense functions in whose implementation society and the state have a preeminent interest.

The group to which a corporation is allocated depends on its objectives and its actual activities. This allocation may be changed in the course of the existence of a corporation.

## 5. Reform of the law governing not-for-profit corporations and charitable donations

5.1 Legislators alone determine the rules with respect to the above groups, in particular their allocation to specific objectives. These rules must not be based to a significant degree on whether these objectives are suitable to ease the burden experienced by the Federal government, L nder, and municipal governments in fulfilling their responsibilities.

5.2 An independent commission will be set up to advise parliament and the Federal government in establishing

and reassessing the principles of public welfare and evaluating individual cases. The members of this commission will be appointed by the Federal president.

5.3 All public-welfare-oriented corporations will be exempted from income and property taxes including inheritance and gift taxes.

5.4 Donations to corporations in Groups B and C above will reduce the donor's taxes. The tax effect will be the same regardless of the nature of the donation (charitable donations, endowment of a foundation, additional donations to a foundation's endowment, membership contributions). Receipts will be issued by the corporation benefiting.

5.5 Donations to corporations in Group C above will result in an increased tax effect for the donor.

5.6 The tax effect of the donation will be in the form of a tax credit. The amount of the tax-reducing share of the donation is to be determined by law.

5.7 Within the framework of other state measures (law governing donations, measures to promote employment, civil service agencies, etc., all public-welfare-oriented corporations will be assessed in the same way.

5.8 Foundations will only be classified as public-welfare-oriented if they are registered in the Register of Foundations (Part A or B).

## D CONCLUDING REMARKS

1. In order to coordinate these reforms with other reform projects, it is possible to conceive of a reform in several stages if the fundamental objectives satisfy those of the overall concept.

2. However, an express warning is to be given regarding the premature putting into force of a separate ordinance to amend the law governing charitable donations which is contrary to the spirit of the reform.

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# BRIEF ANALYSIS OF THE DESIRED REFORM OF THE LAW GOVERNING FOUNDATIONS IN GERMANY

(organized by the Maecenata Institute
and the Bertelsmann Foundation)

We shall examine below the extent to which the Guidelines formulated in the ''Guidelines for Laws Affecting Civic Organizations'' (hereinafter Guidelines) agree with the ideas of the Expert Commission on the Reform of the Law Governing Foundations in Germany. These Guidelines deal with the treatment of civic organizations in their entirety.

The reform, however, pertains primarily to the law governing foundations in its concrete form. Although reform of the entire law governing not-for-profit organizations is recognized as necessary, for organizational, substantive, and political reasons it is not being sought after at the moment.

In order to allow the reform to be compared with the Guidelines, the organization dealt with abstractly in the Guidelines is regarded below as equivalent to the foundation.

## 1. Founding

In principle, the general consensus is that everyone should be entitled to create a foundation. This is both recommended by the Guidelines as well as regarded as an elementary aspect in the reform discussion. Based on this, the founder himself should be entitled to decide on the objective of the foundation. The creation of a foundation whose existence will be limited temporally is a component

of this self-determination, therefore should be made possible in principle.

In the system in place up to now in Germany, a foundation is established and has legal validity as soon as the appropriate approval is obtained from the Land[1] in which the foundation has its residence. The requirements for establishing foundations differ from Land to Land, for example states in southern Germany have higher requirements as a rule than in the rest of the Federal Republic. There is widespread consensus, however, that, in general, the present requirements are obstructing unnecessarily the development of foundations in Germany.

In the opinion of the expert commission, this should be changed and this concession system be replaced by a normative system in the future. For example, creating a foundation should be merely an uncomplicated, simple, and, above all, statutorily prescribed act with which the arbitrariness exercised in some cases by state organs in issuing approvals can be blocked.

Uniform requirements are also to be achieved throughout the entire Federal Republic in the course of the planned simplification of regulations for establishing a foundation. However, legislative competence in regard to foundations lies with the L nder in part, so that a final regulation by the Federal government applicable to all forms of foundations would violate German constitutional law. As a result, the L nder are required to achieve a far-reaching consensus. Nevertheless, amendment of the laws within the framework of Sections 80 - 88 of the [German] Civil Code should be achieved on a Federal level without violating the competence of the L nder.

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1 TranslatorÆs note: Land (LΣnder) = approximately state(s) or province(s).

The necessary result of this change in the legal situation in favour of the normative system is that foundations must be registered in some way. In this regard the future model provides for the entire act of creating a foundation being divided into two parts because the creation of a foundation on a normative basis precedes its registration in a register which is still to be defined.

The Guidelines recommend that the establishment of a foundation require the lowest level of bureaucratic intervention possible and that the requirements for potential foundations not be set too high, especially since large administrative expenses tend to act as a deterrent for potential founders of foundations. The expert commission sees this in the same way.

However, the experts do not agree on whether official recognition should be preceded by notarial recording. For those experts supporting this view, this results, on the one hand, from the legal history of the creation of foundations. On the other hand, this would bring with it a desirable equality of treatment with other juristic forms of corporate law under which notarial recording is

required. Consequently, official recognition would continue û but only as a second step û to be the responsibility of a state organ, more precisely the local court having jurisdiction.

The counter-argument to this is that notaries often are pursuing their own economic interests, which gives rise to fears that the advice given would deteriorate. For this reason L nder authorities should continue to provide advice in the founding phase, especially since they, according to their own statements, have usually played an advisory role rather than a supervisory one in the course of the establishment of foundations and the foundations have found this desirable. Of course, the L nder are interested in giving up as little power as possible and, therefore, want to continue to have advice in regard to founding issues and recognition treated as their responsibility in the future. It was noted as a further criticism that the notarial system, with its registration by the local court having jurisdiction, would make the process of creating a foundation more complicated, which is precisely what implementation of the reform is to prevent. Accordingly, in addition to the financial authorities and the authorities responsible for supervising foundations, who are already involved in the process and whose review standards are not harmonized in any case û which regularly results in problems û a further state institution would be involved in this process, which could lead to new problems once again. Therefore, as long as the system of supervision of foundations is retained, statutory recognition should remain a matter for the authorities responsible for supervising foundations in order not to complicate the process unnecessarily. Where the decision on approval of a foundation is delayed by the authorities beyond a certain necessary period, automatic registration should result. In this regard it is not important whether the delay was

intentional or not. This procedure is also recommended in the Guidelines. Otherwise, state organs could arbitrarily obstruct official approval of foundations once again, which would reduce this part of the reform to absurdity, making it redundant therefore.

However, the fiction of approval is by no means to be regarded as equivalent to, or to be confused with, recognition of the not-for-profit nature of organizations, especially since the selection of the corporate form of the organization to be founded is always independent of the tax law issue of its benefit to the public welfare.

Although a tendency to favour the existing system while taking into account the modifications mentions is evident in the discussion, a final decisions has not yet been made.

2. Transparency and accountability

Transparency means first of all very simply that all information to which the public is entitled is to be made accessible. Therefore, transparency demands that there be a detailed reporting in the different areas of foundation activity.

The Guidelines demand that not-for-profit organizations which have received a relevant amount of money from state or private sources should disclose their operations so that what they have done with these funds is evident. This is also regarded as one of the fundamental principles of the reform of the law.

The arguments for such a procedure overlap in both texts.

Public trust in foundations is seen as an extremely important fundamental aspect, especially since the funds used by foundations usually come from third-party sources and, therefore, must receive special treatment. This should also include the organizations concerned having to show that the money has been used conscientiously and sensibly. It should also be evident to outsiders that, in general, the purpose of the foundation has been pursued and actually realized by the bodies of the foundation. If these proposals are not accepted, it may lead to a profound loss of trust by the public, which could also result in the necessary sources of money drying up in the medium term, money which is given solely in the belief that it will be used in for the purpose intended, and foundations which do not have close connections to companies rely on such funds. This would also be a development which the reform is intended to counteract.

In addition to fiscal reporting, transparency also requires that internal matters be reported on, i.e. the disclosure of internal decision-making structures and criteria and reporting about projects, in other words, as stated, agreement between the goals of the foundation and its actual activities.

In this way, administrative abuses, self-enrichment of members of the Management Board at the expense of the foundation, use of funds for purposes other than those intended, and corruption cannot only be held in check better, in general, but actually detected in the first place.

Consequently, striving to achieve transparency is something that is necessary if foundations are to survive.

3. Supervision

Up to now foundations have been supervised by state authorities. In order to achieve self-regulation and self-responsibility in the foundation sector in the future, both the Guidelines and the expert commission are demanding that the role of the state be limited to the level required. By no means should the state assume the role of an omnipresent watchman. However, the expert commission could not decide conclusively how large its actual influence should be.

Accordingly, only various options for the role to be played by the state were mentioned, from exclusive state supervision to self-regulation of the foundation sector by a foundation chamber.

On the other hand, the Guidelines give priority to as far-reaching a self-regulation of the third sector as possible, which does not mean, however, that the state should play no role at all in this sector. Consequently, supervision should pertain to the goals pursued by the foundation and its actual activities, be exercised continuously in the future, and no longer be restricted solely to the process of establishing a foundation.

However, the state should definitely be responsible for matters relating to registration in order to be able to guarantee a uniform, clearly laid-out procedure, but this should not entitle the state to deny registration for political reasons. It is a different matter if the conformity of the purpose of the foundation with the law is in doubt. In this case it obviously must be possible for the state to object. Of course, the foundation can then take legal measures against the decision.

The supervisory authority lost by the state in the event of self-regulation of foundations can be offset by an

obligation to disclose information on the part of foundations. The state will retain a certain degree of supervision in any case. A general supervisory function for the state results from the mere fact that in the event funds are used improperly, the former can prosecute the foundation in question, and the latter still has to submit tax returns to the state. However, the state should intervene only as a kind of last instance and exercise a supervisory role only in regard to legal issues. After all, the state

can guarantee society a supervisory process which is independent from the organizations themselves. Furthermore, it is only if the state has a certain measure of control û even if only a small measure û that it can counteract the development of subcultures which could endanger the existence of the state in the long run, even if this is definitely not to be attributed to the organizations in their entirety.

It should be possible for the operations of foundations to be supervised by the public or by any so-called watchdog organizations, also those mentioned in the Guidelines, so that state supervision should be replaced by self-regulation, by a foundation chamber for example, one of the possibilities proposed by the commission.

4. Other obligations

As recommended by the Guidelines, which are abstract in nature, the draft bill distinguishes between small and large foundations in so far as their obligations towards the state are concerned. For example, the Guidelines recommend that small organizations be obligated only to prepare simple, small (tax) returns. This is also put forth in the discussion about the reform of the law governing foundations. Accordingly, it is considered sufficient if small organizations provide solely an expense-income list as long as the clarity of the return can be maintained and its truthfulness guaranteed.

In this case, too, the arguments coincide, especially since the Guidelines and the experts want to keep the bureaucratic demands on foundations as low as possible because it is precisely with small foundations that such demands can hinder excessively the effective operation of foundations on account of the disproportionately large

amount of work involved, which also entails new personnel costs, which do not seem proper in view of the result.

5. Economic activity

As a rule, foundations are not allowed to engage in economic activities, unless the law provides for exemptions from this regulation. Accordingly, economic activity is allowed, for example, as long as it can be considered part of the management of assets. This is usually the case if a foundation holds shares in a capital corporation, which should not exceed 50% however. Otherwise, the tax authorities could take the view that the foundation is interested in doing business and not in maintaining assets. This could result in cancellation of its not-for-profit status. Other forms of economic activity are also permitted. However, the expert commission dealt primarily with the question of income from share holdings.

In general, the principles formulated by the Guidelines with regard to economic activity agree with those discussed by the expert commission. Both proceed from the viewpoint that economic activity should be possible, in principle, in order to allow foundations to increase their

budgets, which, in turn, they can use to realize the purpose of the foundation. For example, foundations should generally be allowed to build up voluntary reserves from any profits from sales of any capital investments without having to fear tax disadvantages from this. This is definitely possible under present legislation, but only a maximum 25% of the excess of income over the expenses for asset administration can be allocated to voluntary reserves. The other part must be used within a narrow time period, i.e., income must be used within one year as a rule. However, in the opinion of the foundations this is not sufficient, and they are demanding that this percentage be increased.

Furthermore, profit distributions from shares in capital corporations are subject to corporation tax. These are paid by the capital corporation in the name of the foundation before they are distributed to the foundations. Consequently, foundations do not receive this money back, which they regard as in contradiction to the principle of tax privilege. On the other hand, the investment of funds at fixed interest rates and the resulting net interest earning are not taxed. If the foundation has invested money with a bank at a fixed rate of interest, it receives the resulting interest tax-free, i.e. 100%. In the opinion of the foundations, these different ways of treating income should be changed. It is not only the tax authorities who see this differently, so that it will have to be seen whether the law will be amended in this regard.

The actual purpose of the foundation must not be ignored or outweighed by its economic activity under any circumstances. Consequently, problems can develop if the foundation holds more than 50% of the shares in a capital corporation, especially since the tax authorities cannot help but suspect that the foundation is participating in

business through this company and is not concerned with asset management. Therefore, the demarcation between the second and third sector must be clearly drawn. However, how this should be done could not be decided conclusively. Focusing on the actual primary activities of the organizations, as is also proposed by the Guidelines, definitely appears to be the first step, which is still to be specified, for this necessary delimitation.

## 6. Concluding remarks

If the above remarks are considered, it can definitely be concluded in studying the whole of the discussion that there is agreement between the abstractly formulated Guidelines and their internal realization within the framework of the planned revision of the law governing foundations. Certainly, the discussion has not yet reached a decisive point, especially since there is still no concrete proposal of a bill which is perceived as worthy of passage and which would have to be examined for its agreement with the Guidelines. The expert commission has not yet succeeded in conclusively clarifying the decisive aspects of how foundations are to be established and supervised. In regard to other questions, too, no agreement has been reached as yet. On account of the present political situation in Germany, however, it is not to be expected that a lot of pressure will be brought to bear on implementing the reform, not to mention an amendment to the law, as necessary as it may appear, in the near future.

TIL P RKSEN
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