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Hungary

The Legal Environment for Endowments in Hungary

by

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Although nothing prohibits the establishment of an endowment in Hungary (and it is even encouraged by law as one possible form of creating a foundation) in practice endowments do not exist. "Endowment" is used here in the following sense: an endowment exists within an organization and consists of money and/or property dedicated to a specific purpose. The principal of an endowment must be kept intact indefinitely and only the income from that principal may be used to fulfill the purposes of the organization.

In analyzing the legal environment of such funds, this paper will look at investment opportunities for NGOs in general, even though it concentrates specifically on endowments. Besides the current economic circumstances and limited organizational capabilities of such funds [here I meant limited organizational capabilites of the foundations (NGOs) managing such funds but it is OK], the failure to establish them is probably due to the lack of adequate legal incentives, including unfavorable or unclear regulations in the areas of governance structures. In addition, the Hungarian legal system lacks adequate risk-management concepts, clarity about liability for investment failures, and has insufficient incentives with respect to the taxation of investment returns.

Establishment of an endowment

Interestingly, under Hungarian law the establishment of a foundation in itself involves the possibility of creating an endowment. In the current law, there are two ways to dedicate the property of a foundation, through the so-called "closed foundation", or through the "open foundation".

Art 74/A (1) of the Civil Code (Act IV of 1959) states that "the property required to realize the goals of the foundation must be designated to the foundation" (closed foundation). This means that the fund must be so-dedicated in perpetuity and that the corpus may never be invaded to do the work of the foundation. Art 74/B (4) states that if the founder allows others to join the foundation (open foundation), anyone may join [i.e. contribute to] the foundation, under the conditions laid down in the founding statutes. In this case, only "at least the amount of property that is essential to start its operations" needs to be designated to the foundation.

In the various excerpts from opinions by the Supreme Court (which are binding on the judiciary), the following are pointed out:

> "In case of a closed foundation, its property can only be increased by the yield of the initial capital [and/i.e.] possibly by the income of the entrepreneurial activity." (Since the wording here is not clear, it is also not clear whether, for example, capital gains are by definition considered entrepreneurial activity or not.) In a sense you are right; the wording makes it unclear whether any yield – not only capital gains - would be considered entrepreneurial activity; only

according to the tax law it is OK not to consider interest income on bonds as entrepreneurial activity but there is a question with regard to other methods (see later). So that's why I brought capital gains as an example, because it is another, not obviously tax-free method. If this is too confusing, we can skip it.

"The founding statutes need to determine the method of use of the property, including the stipulation of whether, in order to accomplish the goals of the foundation, all of its assets may be used [expended] or only the capital of the foundation or only the gains of that capital can be used." The Supreme Court also determines that "in case of an open foundation, the founder cannot prohibit the use [expenditure] of the initial capital, because that would be contradictory to the requirement that the funds necessary to start the operation shall be available at the founding." *(Supreme Court Public Administration College, Opinion #2, Section 1[c])*

While it is clear that the first statement (the case of a closed foundation) considers the initial capital as an investment to be harnessed, the latter ones (ways to use the property in the case of both a closed and an open foundation) contradict the notion of the initial capital as an endowment since they clearly allow the expenditure of all of the initial capital for the purposes of the foundation.

In practice, the number of closed foundations is minimal. Founders are not interested in designating large amounts of property to a foundation's purpose in perpetuity. The law has created insufficient incentives and too many barriers to the establishment of an endowment; some of these legal obstacles are detailed below.

Governance and principles of investing

One reason why there may be reluctance to endow foundations is that the governance principles of foundations in Hungary are not entirely clear. Although in principle the founder retains the right to appoint and dismiss board members throughout the life of the foundation (and is also the only person competent to modify the founding statutes), in practice the Hungarian court rulings show a tendency to restrict the founder from active involvement in decision-making about the organization. This is logical and understandable, given the fact that in most cases the founder has made only a minimal financial contribution to the organization. There is also a legal argument that a foundation is a separate legal entity, so the founder should be able to exercise only indirect control over a foundation. At the same time, grant-giving endowed foundations and grant-seeking, operating foundations (essentially NGOs) are not distinguished in Hungary. It is also not possible to set up self-perpetuating boards of directors. The controversies around rights and responsibilities of the founder probably impede those who want to dedicate a greater amount of their wealth to a public purpose by creating an endowment.

Art. 4. (1)(b) of Act CLVI of 1997 on Public Benefit Organizations (PBOs), which lists the criteria for a public benefit organization, provides overall guidance on prudence in financial matters when it states that a PBO "only undertakes entrepreneurial activity in order to further its public benefit purposes and without endangering them".

A concrete example of what a PBO is not allowed to do because it would endanger the realization of its purposes is provided by Art. 16 of the PBO Act: "A public benefit organization shall not issue bills of exchange or other securities creating a debt obligation" and "a PBO, except a public benefit company, shall not draw credit with

the aim of developing its business activity to an extent which jeopardizes its public benefit activity".

Art. 17 of the PBO Act requires that "a public benefit organization pursuing investment activity shall prepare investment rules which are approved by its highest body". Apart from the above-mentioned, however, the law provides no further guidance as to what these policies should involve. Thus, there is no clear guidance as to how a foundation endowment may be invested and the extent to which prudent investment policies govern such investments.

We should also note that the Civil Code and other laws are silent on regulating issues such as the above in the case of foundations that do not have a public benefit status, apart from stating that a foundation cannot be founded for primarily economic purposes (CC Art. 74/B (6)).However, the Hungarian system does have an instrument that could serve as a model. Act XCVI of 1993 established Voluntary Mutual Insurance Funds, in which individuals are allowed to invest in various financial vehicles that provide for financial growth while ensuring prudence. The funds are obliged to maintain an operational and a liquidity fund besides the equity, and an approved financial manager must manage the funds. At least in part, the investment management regulations of the Voluntary Mutual Insurance Funds could be applied – voluntarily by the NGOs as well as by legislation -- to endowment funds of NGOs.

Taxation

In Hungary there is a differentiation between "economic activity" and "entrepreneurial activity" (or, in another translation, "business activity"). Act LXXXI of 1996 on Corporate Tax and Dividend Tax (CTDT Law) defines in its first paragraph (Article 1.1.) "entrepreneurial activity" as "economic activity aimed at or resulting in obtaining income and property". This type of economic activity -- and only this type -- is what a legal person is required to pay tax on, whether it is a for-profit or a not-for-profit entity.

Appendix 6 of the CTDT specifies that in applying Article 1.1 to foundations, public foundations, social organizations, and public societies (e.g., chambers in Hungarian law), from among their economic activities aimed at or resulting in obtaining income and property, the following is *not considered* entrepreneurial activity:

- public benefit activity, or in case of a non-PBO, activity performed in accordance with the statutory purposes;

- revenue received from selling intangible and tangible goods and inventory serving solely the public benefit purposes, or, in case of a non-PBO, the statutory purposes; and

- **part of the interest received from a credit institution or the issuer of securities, or a part of the yield of state bonds**, proportionate to the percentage of revenue from public benefit or statutory activity as related to the entire revenue (revenues counted without the interest and the yield) of the organization.

The difficulty in the interpretation is that while "securities" in legal terminology may mean income from both capital ownership (shares in stock and other ownership rights) and from debenture ownership (interest and other yields), the Hungarian Law

on Accounting (Act C of 2000) explicitly differentiates between the two and later consistently refers to only the second group as "securities".

On the one hand, the CTDT and other laws are not as consistent in using "securities" to mean only debt obligations. On the other hand, in the paragraph above, the CTDT refers to only "interest" received from the "securities," and so it is not likely that it was the intent of the lawmakers to include shares under this heading. Under this interpretation, a foundation would not be able to invest in a perpetual ("open-ended") investment fund free of tax, even if the specific portfolio would include only bonds, since such ownership is considered a form of shareholding.

All in all, if a PBO does not have commercial activity at all, its income from investments in credit-type securities (bonds, whether government or corporate-issued) will not be counted as entrepreneurial income. On the other hand, income from investments in shares, limited partnerships, and perpetual investment funds will be tax exempt only as long as it is under 10% of its total revenue or less than 10,000,000 HUF (in other words, it will be treated as income from entrepreneurial activity.[1]

Liability

As pointed out by ICNL in its memorandum on the same issue for Poland (Legal Environment for Endowments in Poland, May 2001, by Dr. Leon E. Irish, President of ICNL), civil law countries do not have the concept of trust and fiduciary duty in the sense used in common law countries, such as the England or the United States. In common law countries, issues of liability with respect to endowment funds have largely been derived from trust and fiduciary law. The issue of liability for bad investment decisions is not clear at the present time in Hungary, as the issue of liability of board members and management is not clear in general.

The most concrete reference to such liability is in Art.74/C (6) of the Civil Code that determines the liability of the foundation for damages to a third party caused by a board member or official of the foundation; and states that the board member or official is liable to the foundation according to the general tort rules of the Civil Code.

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[1] Unfortunately, most PBOs are unaware of these issues and PBOs do not take advantage of these opportunities.