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MEMORANDUM

TO: Bob Thomas

FROM: Lee Irish

DATE: 16 May 2001

SUBJECT: Legal Environment for Endowments in Poland

1. Background and Overview.

The Polish NGO sector is among the most dynamic and sophisticated in the Central and Eastern Europe (CEE) region. Poland's new Constitution guarantees the freedom of association. Since the mid-1980s Polish law has provided for two legal forms for NGOs -- associations (membership organizations) and foundations (non-membership organizations). Both the Law on Foundations and the Law on Associations have undergone significant revision since 1989. The current NGO legal framework in Poland is somewhat complex and confusing yet functional. NGOs can generally be formed without undue delay or expense, and, once formed, can operate quite freely, engaging in traditional social service provision as well as advocacy activities. Significant tax advantages are provided to both associations and foundations.

Substantial obstacles do exist for foundations, however, with respect to using economic activities to achieve their statutory purposes and in partnering with local government. These problems result from defects in existing legislation and restrictive interpretations of the laws by the courts. This Memorandum, however, will focus on the legal environment for endowments in Poland, including the case

involving the Foundation for Polish Science, which threatens to make properly invested endowments infeasible in Poland.

Additional information and analysis about the general legal framework for NGOs in Poland can be found in the Poland Country Report written by ICNL for the Council on Foundations: <http://www.usig.org/countrycodes/poland>
Laws and other documents relating to NGOs in Poland that are in the ICNL database can be found at: <http://www.icnl.org>

2. Establishment of Endowments

The Polish Law on Foundations, Dz.U. No. 19, item 82, as amended Dz.U. No. 46, item 203 and regulations promulgated there under are silent as to the establishment of endowment funds or other forms of investments by foundations. Furthermore, the concept of an endowment is relatively new in Poland. Professor Hubert Izdebski in his leading treatise, Foundations and Associations, observes that the foundations in general do not rely on investment returns on endowments for their operating income. The operations of virtually all Polish foundations are instead supported either by donations (fund raising) or economic activities.¹

One feature of the Law on Foundations could be argued to apply to endowments. Under that law foundations are allowed to engage in economic activities as long as any profits from those activities are used for the public benefit purposes of the foundations and so long the statute of the foundation explicitly describes the permitted economic activities. It could be argued that investing is an economic activity and that, if it is provided for in the statute of a particular foundation, the investment of an endowment is a permitted statutory purpose.

Unfortunately, this argument is not likely to succeed. Under Article 2.1 of the Law on Economic Activities dated December 23, 1988, Dz. U. No.41, item 324, as amended, "economic activities" consist of one or more active businesses -- production, construction, trade, or services. It is likely that this concept of "economic activities" would be carried over to the Law on Foundations and that investment activities, which are generally considered to be "passive activities" would probably not be considered economic activities as that term is used in the Law on Foundations. This would be especially true in the case of portfolio management for a fee by a professional third party provider, for in that case there would be no activity by the foundation other than the selection and oversight of the portfolio manager. In sum, passive investment activities will in all likelihood not be considered economic activities for purposes of the Law on Foundations.

3. Methods of Investing.

¹ H. Izdebski, *Foundations and Associations*, Wydawnictwo Transit, 1997, at 47.

Art. 3.3 of the Law on Foundation provides the following list of assets that the foundation can hold: currency, securities, donated personal, and real property, and no Polish law prohibits foundations from acquiring or investing in securities. Accordingly, it is permissible for foundations to invest in equity instruments and not just maintain their funds in bank accounts.

Another issue is the degree of investment risk that can be assumed by foundations. In common law jurisdictions managers of endowments are required to act prudently and to diversify investments. A manager must take into account both potential risks and possible yields, and under the "portfolio management" theory, it is appropriate to hold a variety of kinds of investments and to balance the portfolio so that there are some high-risk, high-reward investments as well as more conservative ones.

In this respect, the Trust Investment Act of 1961 is clearly relevant. Consistent with its provisions, a donor may determine the forms of permissible investments in the trust or grant instrument itself. Furthermore, a board of directors or trustees should develop for the foundation an investment policy that assures an appropriate balance of capital growth and a flow of income. The boards of directors or trustees have a choice of managing investments internally or externally. Unless the foundation has adequate investment expertise on staff, it is more prudent to select a professional fund manager to manage the investments. The manager should be instructed to maximize returns while maintaining a level of risk consistent with the investment policy appropriate for the particular endowment.

Currently there are no regulations or guidelines in Poland on these issues with respect to endowments of foundations. There is guidance, however, in the Law on Pension Funds, enacted on June 25, 1997, with effective date of January 1, 1999, and it can be argued that these standards provide relevant guidance for endowments as well. Article 141 of the Law on Pension Funds includes a list of 13 types of permissible investments, including securities. This legislation puts a heavy emphasis on the diversification requirement. Article 142 consists of specific rules about how investment holdings should be diversified.

Unlike other countries in CEE, Poland has created a coherent regulatory framework for professional management. In 1997 the Sejm enacted both a Law on Investment Funds and a Law on Public Trading of Securities ("Securities Law"). Article 38 of the Securities Law defines asset management activities as making and implementing investment decisions for the account of a client. Such management activities must be within the scope of authority given by the client. Portfolio management services can be provided by brokerage houses and banking institutions licensed by the Securities Commission to provide portfolio management services. Foreign institutions licensed in OECD countries to provide brokerage services can operate in Poland (Art. 52 of the Securities Law). Furthermore, authorized portfolio

managers can trade in securities on regulated foreign exchanges in the OECD countries (Art. 30.3 of the Securities Law). The issue of investing abroad will be further discussed below in connection with foreign exchange laws.

Currently, a number of financial institutions offer asset or portfolio management services. For example, the Centrum, Operacji Kapitałowych is a licensed investment arm of Bank Handlowy which offers portfolio management services through its asset management division. J.P. Morgan, with 12% of the equity of Bank Handlowy, is its largest shareholder. Other domestic institutions like Bank Przemysłowo-Handlowy or BANK PKO BP also offer investment and brokerage services.

Among foreign banks offering fund management services is ING Bank. Although ING Bank (as opposed to Bank Handlowy) does not have a seat on the Warsaw Stock Exchange; it does offer fund management services through its corporate banking department. Although membership in the Warsaw Stock Exchange is not a prerequisite for being a portfolio manager, it does indicate a serious commitment to the investment and brokerage services of a particular financial institution. Among foreign banks that are members of the Warsaw Stock Exchange are Citibrokerage, Raiffeisen Capital, and Pionier Polski Dom Maklerski.

4. Foreign Exchange.

The Foreign Exchange Law dated December 2, 1994, Dz.U. No. 136, item 703, as amended, establishes the legal framework for dealing in foreign exchange. For purposes of this law, foreign exchange includes both currency and securities. As a general rule, domestic persons may not hold foreign exchange abroad unless permitted by the Ministry of Finance.

A Regulation of the Minister of Finance on General Foreign Exchange Permits dated January 16, 1996, Mon. pol. Np. 6, item 73, as further amended ("Regulation"), provides that domestic persons may transfer foreign exchange to OECD countries and other countries that are signatories to bilateral treaties on investments with Poland for purposes of acquiring securities that are publicly traded in these countries. Such acquisition must be made through authorized domestic persons that are fully licensed by the Ministry to engage in these activities. Accordingly, investing in securities or mutual funds traded in any OECD country is possible but such investment have to be made through a licensed Polish broker. If a Polish brokerage house provides portfolio management services, investments in foreign securities could be provided for in the portfolio/asset management agreement.

The Regulation also requires that a domestic person interested in transferring foreign exchange in the amount of more than 50,000 ECU (now EUROS) abroad for purposes of acquiring foreign securities must notify the National Bank of Poland by

filing an appropriate form. Transfer of foreign exchange can take place 3 months from the filing date (Art. 20a.2). Regulatory restrictions on investing abroad are likely to be relaxed even further as a result of adjustments for European Union membership in accordance with the European Union Association Agreement.

5. Liability.

The issue of liability for bad investment decisions is not clear at the present time. A major reason is that, being a civil law country, Poland does 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, issue of liability with respect to endowment funds has largely been derived from trust and fiduciary law.

The Law on Foundations provides one mechanism that could be used to sanction improper investments. Article 14 states that the Minister overseeing the operations of a particular foundation may call on the management board to take action or refrain from certain action or request the removal of the management board in the event the management board acts (i) in violation of law, (ii) in violation of the statute, or (iii) in violation of the purposes of the foundation. There is no reported instance, however, when this authority has been used with respect to investment decisions.

Another relevant piece of legislation may result in criminal liability. The Law on Safeguards of Business Operations dated October 12, 19941 Dz. U. No 126, item 615 ("Safeguards Law") may be applicable to the investment decisions of the management boards of the foundation. Article 1.1 of the Safeguards Law provides that whenever a person responsible pursuant to law, administrative decision, or contract to manage assets of a third party, abuses its authority or does not fulfill obligations and consequently causes damages to the third party, that person may be sentenced to prison for 1 to 10 years. Again, there is no reported instance of this sanction being used against those responsible for improper investment of an endowment fund.

The general rules of donation, inheritance, and tort law may also come into play under the Polish Civil Code. For example, liability pursuant to the operative grant/gift instrument may arise under Title XXXIII of the Civil Code. Pursuant to Article 893 of the Civil Code, a grantor may impose specific obligations on the grantee, which could include investment obligations or limitations. If the public interest is involved, an appropriate government entity may seek compliance with the grant/gift instrument (Article 894 of the Civil Code).

The question of the liability of portfolio managers who handle the investment of endowments is fairly clear, thanks to the relatively new legislation on investment funds. Pursuant to Article 44.1 of the Law on Investment Funds, an investment

company is liable for damages resulting from non-performance or inadequate performance of its portfolio management responsibilities. An almost identical provision is included in Article 48 of the Law on Pension Funds.

In Polish law there is no equivalent of the American Trustee Investments Act of 1961, which defines the standards for determining the reasonableness of investments as well as the legal and financial responsibility of the Trustees. In a nutshell, US trustees are required to (i) abide by the provisions of a deed of trust, (ii) act in a reasonable and prudent manner, (iii) diversify investments, (iv) seek independent financial advice, and (v) use due care in their all their investment dealings. Trustees are personally liable for failure to live up to these requirements.

The management board of a Polish foundation that has an endowment is essentially in the same position as trustees of a U.S. foundation, and it would be good practice for members of a management board to follow the standards established in the Trustee Investments Act, especially in dealings with the American donors.

6. Taxation.

Tax liabilities are governed by the Law on Income Taxation of Legal Persons dated February 15, 1992, Uniform Text Dz. U. of 1993 No. 106, item 482, as further amended ("Income Taxation Law"). Turning to the kinds of revenues that can be earned from endowments, interest on investments generally constitutes taxable income under Article 12.1.(1). However interest income from treasury bonds may be exempt under Article 17.1-19. Furthermore, foreign legal persons are taxed at a 20% rate on interest income received unless a bilateral treaty on double taxation provides otherwise (Article 21.1.).

Dividends and other revenues realized from participation in profits of a legal person constitute income and are also taxed at 20% rate (Art.22.1.). Traditionally, capital gains have not been taxed in Poland. However, under Article 10-1., which was added in 1997, income that is realized from participation in profits of a legal person, including the value received in connection with the liquidation of a legal person, is considered income for income tax purposes.

Different tax issues arises in connection with taxation of portfolio investments. The Law on Investment Funds of 1997 amended the Income Taxation Law to exempt from income taxation investment funds formed under the Law on Investment Funds. This in effect makes investment funds into "pass-through" entities, with the result that taxes are imposed at the investor level.

Foundations that operate in Poland rely on tax exemptions provided in Article 17 of the Income Tax Law. Pursuant to Article 17.1.(4), income of taxpayers

whose statutory purposes are education, sport, cultural activities, physical fitness, health, social services, environmental protection, support of rural development, or religion, is not subject to income taxation in that part of its income that is designated for the above statutory purposes. However, income that is used to support other worthy purposes, such as the care of injured or homeless animals or the development of a free market economy is subject to taxation.

A recent decision of the Supreme Administrative Court (NSA) has deeply shaken the Polish foundation world. This decision, unless reversed, will make it impossible to establish or maintain a properly invested endowment. The Foundation for Polish Science (FNP), with an endowment of about \$75,000,000, invested a large part of it in state bonds and traded equity securities. In 1998 the office of tax inspection audited FNP for the years 1995-1997 and assessed a bill for back taxes and interest of about \$20,000,000. The tax authorities took the position that the purchase of securities was an expenditure that was not for statutory purposes and therefore the exemption under Article 17.1.(4) was unavailable. Only money placed in fixed-rate bank deposits would escape income taxation.

The decision of the tax authorities was upheld by the Tax Revenue Chamber, whose decision was in turn affirmed by the Supreme Administrative Court. In doing so the NSA rejected the argument of the FNP that it had designated its endowment and any income earned on it for exempt statutory purposes and that it had purchased securities only to assure that there would be an adequate return on its endowment.

The NSA did make one favorable ruling in the FNP case. It held that financial support through grants to institutions that carry out statutory activities (e.g., a grant to an institution to do scientific research) qualified for the exemption of Article 17.1.(4). It was not necessary for the FNP to directly conduct all of the statutory activities that it supported.

The practical effect of the decision in the FNP case is to limit investments by endowed Polish foundations to interest-bearing savings accounts in banks. The premise of the ruling is that any other kind of investing is an expenditure for a non-statutory purpose. Money placed in a savings account is regarded as not having been expended.

7. Conclusion.

Poland has probably gone farther to establish an enabling legal environment for investment and portfolio management than any other country in Central and Eastern Europe. Poland has developed a small but growing capital market that offers readily tradable securities, but it has also put in place rules that allow diversification through foreign investing. On their face the income tax laws allow

exemption for the income of foundations engaged in a wide variety of public benefit activities. The recent adverse decision of the NSA in the FNP case, however, poses a serious threat to the growth and viability of endowed foundations in Poland.

It is likely that the recent decision of the NSA will be appealed to the Supreme Court of Poland. A group of civil society organizations in Poland, including the Forum for Non-Governmental Organizations (FIP), the Academy for the Development of Philanthropy in Poland (ARFP), the Polish Foundation Forum (PFF), the Foundation Notwithstanding Stormy Weather (KLON), and the Support Office for the Movement of Self-Help Organizations (BORIS), has formed to study the problem and propose legislation to rectify it. It will be important to follow both developments to see what the ultimate resolution of this difficult issue is.