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ECONOMIC ACTIVITIES OF NOT-FOR-PROFIT ORGANIZATIONS

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I. Introduction

As the countries of Central and Eastern Europe (CEE) and the Newly Independent States of the former Soviet Union (NIS) develop laws governing the not-for-profit sector, each must address "economic"/"commercial" activities of not-for-profit organizations (NPOs) ¹. This issue is intricately linked with broader questions concerning the definitions and boundaries of the three sectors of society--governmental/state, commercial, and not-for-profit. There are also implications for macro-economic and micro-economic policy, governmental and legal structures, and even the relationship between individuals and the state.

Despite the breadth of their implications, legal issues relating to the "economic" or "commercial" activities of NPOs in the CEE and NIS countries lend themselves to fruitful categorization and analysis. In this process, it is useful to consider practices in the United States and Western Europe, as well as developing experiences in the CEE and NIS. This helps illuminate the policy trade-offs inherent in choosing one approach over another.

To place the analysis in context, Part II discusses the defining legal characteristics of NPOs. Part III examines various definitions of "economic" and "commercial" activities. Part IV analyzes the extent to which "economic" and "commercial" activities are consistent with not-for-profit status, regardless of whether such activities are taxed. Part V outlines general approaches to the income tax treatment of such activities, focusing on advantages and limitations of three models: (A) taxation of all or substantially all NPO economic or commercial activities; (B) the "destination of income" approach and variations thereupon; and (C) differentiation based upon the relationship or "relatedness" to the NPOs public benefit purposes. ² Part VI summarizes the analysis.

II. Assumptions Concerning the Defining Legal Characteristics of NPOs

Before attempting the task of defining and analyzing "economic" and "commercial" activities of NPOs, it is necessary to identify and describe defining legal characteristics of NPOs. These attributes are generally described below. For a comprehensive review of this and other issues, please see the Open Society Institute Handbook on Laws for Civic Organizations (prepared by ICNL, 1996).

The first assumption is that the legal entities under consideration are all organized and operated *primarily* for some purpose other than private gain. The emphasis here is not on avoiding the generation of *profit* (in the sense of an excess of revenues from all sources over expenses of all types), but rather on the existence of a substantial *public benefit purpose*.³ This is often referred to as the "principal purpose" test.⁴ The different interpretations given to the "principal purpose" test are discussed further in Part III below, in the context of the definition of "commercial" activities.

A second characteristic of NPOs is that they are prohibited from distributing net revenues to private parties who might be in a position to control them for personal gain, such as founders, members, officers, directors, agents, employees, and other natural and legal persons closely related to these parties.⁵ This prohibition does not generally extend to distributions, even to private parties, which are designed to further public benefit purposes (such as charitable donations to the poor). However, this assumption removes from the scope of this discussion many mutual benefit organizations which make distributions to their members and do not grant similar benefits to the general public.

A third assumption is that these characteristics are not primarily dependent on the legal form of the organization. In other words, the activities and purposes of the organization, rather than the characterization of its legal personality, are most significant. Accordingly, this paper addresses what are varyingly known as associations, foundations, trusts, non-stock or charitable corporations, public benefit companies, and even unregistered and unincorporated organizations under certain legal systems, as long as they serve a public benefit and uphold the principle of non-distribution.

III. Definitions of "Economic" and "Commercial"

The task of defining "economic" and "commercial" activities of NPOs is best begun by identifying the fiscal transactions which are generally considered *not* to fit into these categories. Transactions generally deemed not to be "economic" or "commercial" include: the receipt of purely gratuitous gifts, grants,⁶ donations, and contributions;⁷ the receipt of net revenues from passive investments;⁸ and the use of any funds from these sources to advance the public benefit purposes of the NPO. A variety of other activities may be excluded under specific tax systems.

The broadest definition that might reasonably be assigned to "economic" activities is the active sale of goods or services--often referred to as "trade or business" activities. However, exclusions from this expansive definition exist in most of the CEE and NIS countries, as well as in Western Europe and the United States.

The first commonly recognized category of exclusion relates to isolated, irregular, or occasional activities, which do involve the sale of goods or services, but which are not pursued with the frequency or continuity characteristic of comparable practices in the commercial sector. Examples include raffles, occasional fund raising dinners, and charity auctions. These activities are principally a form of fundraising (subject to appropriate rules on fundraising), but are not generally treated as economic activities because they are not regularly carried on for commercial purposes.

A second group of NPO activities often recognized as non-economic in nature (although they involve the sale of goods and services) are those activities primarily or exclusively carried out with volunteer labor and/or donated materials. The fact that charitable donations and volunteer work generally serve the public benefit justifies this category of exclusion. An example of this is a thrift or second-hand store operated by an NPO to generate profits which are devoted to its public benefit purpose.

A third broad category of exclusion recognized by many legal systems, which may overlap with the second category above, is derived from historical practices or traditions. This category includes activities which are considered to be intrinsically connected to the public benefit purposes of certain NPOs. Depending upon the legal system, examples may include admission fees for museums, tuition payments for instruction at educational institutions, or even fees from patients at not-for-profit hospitals. Fees of this sort are so well-established that they are often excluded from the definition of economic activities. It may also be that they are not thought as *separate* trades or businesses because the fee is so integral to the principle activity of the organization -- e.g., culture, education or health care. Because these exclusions are based on traditional or historical conceptions of the public benefit, examples are often country-specific.

Accordingly, "economic" activities of NPOs may be generally defined as regularly pursued trade or business activities involving the sale of goods or services and not involving activities excluded under some distinct tradition. The next issue is whether all "economic" activities are necessarily "commercial" in nature.

United States law illustrates the conceptual confusion surrounding the distinction between "economic" and "commercial" activities. Although the Internal Revenue Code and Treasury Regulations (the primary sources of federal law governing NPOs in the United States) barely use (and never define) the term "commercial," various American courts and commentators have created a loose doctrine of "commerciality." Most commonly, the issue is whether an NPO's activity has a direct "counterpart" in the commercial sector. The following factors have also been suggested to indicate inappropriate "commerciality": profitable operation and the accumulation of profits, competition with for-profit firms, extensive and successful expansion, and the use of paid workers.⁹

Dutch law also incorporates an element of "commerciality": NPOs are permitted to engage in economic activities so long as they do not substantially compete with private sector enterprises. (This rule is modified to allow NPOs to operate in certain targeted areas such as health care.) Current Romanian law contains a similar principle, denoted "economic character." Only activities with economic character are taxed. Economic character is defined by example, and includes sales, the performance of services or professions, and income from events.¹⁰ The receipt of donations and membership dues is deemed not to have any economic character. However, there is disagreement regarding whether this doctrine is in actuality a test of commercial manner, or whether it subjects all "economic" activities to taxation, regardless of the manner in which they are conducted.¹¹

Approaches based on "commerciality" seek to address several concerns: a blurring of the line between the not-for-profit and commercial sectors; the potential for abuse of NPOs for private gain; and the threat of unfair competition between economically active NPOs and the commercial sector. Implementation of this conceptual design is difficult, however, because there is a lack of consensus on what constitutes a commercial "counterpart" or "substantial competition." Moreover, these approaches require government officials (or judges) to undertake exceptionally complex microeconomic analyses of industries and NPO activities to determine whether the conditions of the particular test are met.

Arguably, no precise conclusion emerges from the preceding discussion distinguishing between the definitions of "commercial" and "economic" when used to describe NPO activities. The use of the term "commercial," however, does add an additional factor to this analysis, by focusing attention on whether the *manner* in which the NPO carries out the activity is clearly distinguishable from the *manner* in which traditional for-profit organizations carry out similar activities. Accordingly, it may be appropriate to speak of "economic" activities when an NPO regularly engages in active trade or business activities involving the sale of goods or services, unless the activities fall under some traditionally excluded area. We can then define "commercial" activities as a subset of "economic" activities consisting of those activities for which there is a for-profit "counterpart."

IV. Are NPOs Permitted to Engage in Economic or Commercial Activities?

A threshold issue is the extent to which NPOs should be permitted to engage in economic or commercial activities and retain their not-for-profit status. At this stage of the analysis, the question is not whether such activities should be tax-exempt, but whether there should be a limit to the amount of economic/commercial activities undertaken by an NPO.

The "principal purpose" test discussed above provides one model. This test seeks to ensure that the organization is established and operated *primarily* for public benefit purposes, and not private gain. Accordingly, an NPO that consistently spent more than fifty percent of its funds or resources would be required to reregister as a for-profit entity. This helps ensure a clear distinction between the two sectors.

A second approach is the so-called "destination of income" test. Contrary to the "principal purpose" test, the "destination of income" test, in its pure form, entirely ignores the economic or commercial nature of the activity in question, and instead focuses exclusively upon the purposes for which profits are used. Under this test, an organization must devote all of its income to public benefit purposes in order to qualify as an NPO. Accordingly, a purely commercial enterprise which is organized using a not-for-profit legal form and which devotes all of its profits to public benefit purposes might enjoy the same legal treatment as an NPO accomplishing similar goals with donated funds. Unfortunately, this may lead the public to view NPOs as a means of avoiding taxation. This image, once created by even a limited number of NPOs damages the reputation of the entire sector. In Bulgaria, for example, the lack of effective regulation of economic activity led to a governmental backlash against the sector, which has severely impeded legislative initiatives in the country.

The distinct focus of the "destination of income" test highlights an additional point. Under this test, it is completely irrelevant whether the profit-generating activity is carried out directly by the NPO that will utilize the income, or by another organization (such as a subsidiary or affiliate). In certain instances, the "principal purpose" test is applied in the same fashion. However, some jurisdictions require that a distinct entity with separate financial records carry out the profit-generating activity (particularly activities unrelated to the public benefit purposes of the organization).¹² Proponents argue this approach limits NPO liability in the event that the activity loses money and minimizes public perception that NPOs are merely for-profit entities in disguise.¹³

Under either rule, an NPO is permitted to engage in economic activities that further the public benefit purposes for which it is organized. There are two principal justifications for permitting NPOs to engage in such activities. First, income from economic activities is a primary source of funds for NPOs (particularly in countries in a transitional phase where there is an absence of private capital and philanthropic traditions), thereby reducing their reliance upon both government and private sources of funding. Second, certain economic and commercial activities directly accomplish public benefit purposes. For example, although sales of a book on teaching techniques by an educational organization is an economic activity, the distribution of the book directly serves the public benefit purpose of promoting education. Preventing NPOs from using such commercial and economic means to attain their goals would directly impair their ability to serve public benefit purposes.

V. Income Tax Aspects of Economic Activities

A. Introduction and Country Survey

Once it is decided to rule out polar extremes--a complete prohibition against economic activities and allowing economic activities to be the principal activity of the organization--the issue becomes the tax treatment of such activities. Three general approaches exist, as indicated by the country survey below. The first approach is to tax income from all economic activities, regardless of the source or destination of the income. The second approach is to apply a "destination of income" rule, exempting income from economic activities which is used for public benefit purposes. The third approach focuses on the source of the income, granting an exemption only when it results from activities which are "related" to the public benefit purposes of the organization. A survey of countries utilizing the three general approaches follows.

1. The practice of taxing the economic activities of NPOs broadly defined:

- In Ukraine, NPOs face 28 different kinds of tax on economic activity. There are no general exemptions available to NPOs, although some historically favored groups have received exemptions (such as veterans groups).
- Until recently, Estonia imposed taxes on all "economic" activities of NPOs, which are broadly defined to include income from charitable events as well as business activities. Lithuania also taxes income for NPOs, but at a significantly reduced level of five percent.
- The Kyrgyz Republic taxes all economic activities of public associations, but provides lower rates for certain traditional public benefit purposes, such as education and medical training.

2. The practice of making taxation contingent upon the destination of income:

- Poland considers income earned by foundations to be tax exempt if it is devoted to public benefit goals which are specified in the tax law.¹⁴
- The United Kingdom exempts income earned by for-profit entities established by charities if the income is used exclusively for charitable purposes.
- The Czech Republic taxes profits on economic and commercial activities related to the public benefit purposes of NPOs, but 30% of the tax base or 3 million CZK (about US\$100,000) of the profit, whichever is less, is exempt from

tax if used to further public benefit purposes.¹⁵ Income from unrelated activities is fully taxed.

3. The practice of making taxation depend upon the related nature of the activity:

- The United States grants a tax exemption for income from economic activities which are related to the public benefit purposes of NPOs, but taxes all income resulting from economic activities which are not so related.
- Germany requires 1) that economic activity be directed towards the accomplishment of the organizations public benefit purposes, and 2) that the economic activity be necessary to achieve these purposes. Otherwise, no tax exemption is permitted.
- Hungary takes yet another approach, providing a list of activities (with a "catch-all" provision) which are exempt from taxation. Income from other activities is taxed unless it is less than 100,000 HUF or 10% of the organizations gross income.

Of course, it is also possible to create a hybrid approach, based on two or more of these approaches. For example, it is possible to allow net income from economic activity to be tax exempt under a specified threshold and to apply a "relatedness" test to determine whether net income over that threshold should be taxed.

As a general proposition, there is no consensus concerning which system best serves the interests of NPOs and governments. Divergent approaches reflect diverse socio-economic conditions, legal traditions, and legislative/administrative developments. Some commentators also suggest that this indeterminate state of affairs reveals underlying disagreement concerning the proper function of NPOs, and distinct psychological and institutional approaches to standards of equity and justice in particular countries.¹⁶

Perhaps there is somewhat greater consensus surrounding the policy framework for analyzing these different approaches. This paper identifies and applies five criteria for this analysis: the simplicity or complexity of administration; the effects on revenue collection; the effects on the commercial sector; the effects on the development of the NPO sector; and practical concerns about implementation. Other criteria are certainly relevant, but this framework sheds analytical light on the practical implications resulting from each approach.

B. Taxation of All or Substantially All Economic and Commercial Activities

The first general approach is to tax all income from economic and commercial activities, regardless of the source or destination. Ukraine follows this approach. Until recently, Estonia followed this approach, and Lithuania is moving in this direction.

1. Theoretical Explanation and Rationale

Proponents of this approach believe that providing tax preferences to NPOs results in "unfair competition," which harms for-profit organizations. The argument is that tax exemptions reduce the marginal cost of capital, thereby lowering production costs for NPOs. Many commentators believe that tax-exempt profits give NPOs higher post-tax rates of return on their business activities than for-profit organizations. Tax-free profits may also enable NPOs to maintain lower profit margins on their economic activities. This advantage could be used to reduce prices on goods and services below levels which are competitive, or even sustainable on the part of for-profit organizations. New participants often enter markets in this way, and in competitive markets entry itself can harm existing economic actors. Once an NPO begins operations and gains market share, for-profit organizations may be driven out as a result of competition for the diminished market which remains. Also, tax exemptions may provide NPOs with a larger capital base, which can be utilized to finance expansion and outbid for-profit organizations for land and facilities.¹⁷ In summary, proponents of this approach argue that with the possible exception of certain traditional public benefit activities, it is necessary to tax all economic activities to place NPOs and for-profit organizations on equal footing in the marketplace.¹⁸

2. Analytical Criteria

(a) Simplicity or Complexity of Administration: A principal advantage of this approach is its administrative simplicity. While traditional/historic exceptions or application of the doctrine of "commerciality" would reduce the level of simplicity, the concept that NPOs should be treated as any other organization for tax purposes is not difficult to apply. Additionally, creation of a broad tax base can minimize the potential for abuse.

(b) Effects on Revenue Collection: The tax base depends on the number of taxpayers and their associated income. Taxing all economic activities would likely decrease the number of NPOs engaging in such activities. Thus -- perhaps contrary to intuition --

this approach potentially reduces the tax base. Therefore, without empirical analysis, it is difficult to determine the effect of this approach on revenue collection.

(c) Effects on Commercial Sector: This approach creates the fewest concerns over unfair competition between NPOs and for-profit organizations. Since both are taxed on economic activities, they have virtually equal status.

(d) Effects on the Development of the NPO Sector: This approach depresses the development of the not-for-profit sector. NPOs operating under this legal regime must pay tax on economic activities even when they are related to public benefit purposes. Thus, they are limited in their ability to financially sustain their operations. This approach also fails to provide incentives for NPOs to engage in public benefit activities involving an economic or commercial component (such as an association for the blind selling walking canes), since these activities would be fully subject to tax.

(e) Practical Implementation Issues: From an accounting standpoint, it is often difficult to determine NPO income and expenses attributable to a specific project. Moreover, this approach still requires a determination of which activities fall within the definition of "economic" or "commercial" activities.

C. "Destination of Income" Rule

The second approach is the "destination of income" rule. Countries applying some form of this approach include Poland, the United Kingdom, Czech Republic, Croatia, Denmark, and Ireland. The source of the income (whether or not the profitable activities are related to the public benefit purposes of the NPO) is irrelevant. Instead, tax treatment depends entirely upon the use of the income. Any income which is devoted to public benefit purposes is not taxed.¹⁹

Some countries place an upper limit on the amount of income that is exempt under this approach. In Croatia, for example, the tax exemption is limited to 50,000 kunas (approximately US\$10,000).²⁰ In the Czech Republic, income up to approximately US\$100,000 is exempt from tax if used to support public benefit activities.²¹

1. Theoretical Explanation and Rationale

This approach is based upon the premise that tax exemptions should help to subsidize activities which benefit the public. Therefore, only income actually spent in a legitimate effort to further public benefit purposes should be exempt. Proponents of this rule

assert that tax preferences are appropriate for activities which would or could be properly undertaken by the government to improve the situation of the citizenry.

Many countries applying the "destination of income" rule place a limit on the level of the exemption, either in absolute terms or based upon a percentage of the income or tax base. While establishing a numerical limit is a simple means of limiting revenue losses for the government, any particular choice is, in the final analysis, somewhat arbitrary.

2. Analytical Criteria

(a) Simplicity or Complexity of Administration: This approach avoids the necessity of conducting an in-depth analysis of the source of income to determine whether it is related to the NPOs public benefit goals (or whether the activity has commercial counterpart). Nonetheless, it is necessary to ascertain whether the income is spent on public benefit goals, which is often difficult to determine.

(b) Effects on Revenue Collection: Of the three approaches, this rule in its purest form would likely generate the lowest level of tax revenue. As long as income is devoted to public benefit purposes, there is no tax liability. Revenue loss can be minimized by imposing a cap on the amount of income exempt from tax.

(c) Effects on Commercial Sector: This rule will likely give rise to the strongest claims of unfair competition. For example, if a foundation established to aid the poor receives income from the manufacture and sale of radios, such income would be tax free if applied to public benefit purposes. However, this tax benefit might allow the foundation to remain in the market even if it is less efficient than its for-profit competitors. Moreover, if NPOs take advantage of this rule and engage in completely unrelated income-generating activities, this may lead the public to view NPOs as nothing more than cleverly crafted businesses. Thus, this approach potentially entails serious macroeconomic consequences for the business sector and has the greatest chance of promoting public distrust of the not-for-profit sector. It may also attract more unscrupulous individuals seeking to use NPOs for tax evasion than the other approaches.

(d) Effects on the Development of the NPO Sector: When there is no limit to the exemption, this approach provides the greatest level of financial support to NPOs. Even if limits exist, NPOs still have access to a defined level of tax exempt income from economic

activities. However, it is important to remember that time limitations on the expenditure of income can create disincentives to the formation of endowments, and other related accounting problems.

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(e) Practical Implementation Issues: The most difficult implementation issue is determining what constitutes a valid expenditure in furtherance of an organizations public benefit purposes. Specifically, what connection is required between the expenditure and the NPOs purposes? Money spent on food for the poor is key to the goals of a foundation fighting hunger. But is job training (arguably enabling the beneficiaries to find employment which will result in money for food) sufficiently related? What about child care services which will enable the beneficiaries to search for employment? Basically, it is difficult to draft and implement legislation or regulations which adequately define the required connection between the expenditure and the public benefit purposes. Therefore, determinations must often be made on a case-by-case basis.

A derivative of this rule, under which income from economic activity below a certain threshold is tax-free, also raises interesting implementation issues.

For example:

- (1) what should be the threshold,
- (2) should the limit be based upon gross revenue or net income, and
- (3) what can be done to prevent NPOs from dividing into multiple organizations to avoid paying tax on economic income above this threshold?

D. The "Relatedness" Rule

Under this approach, the income from economic activities which are related to the public benefit purposes of an NPO is exempt from taxation. Variations upon the "relatedness" rule are in effect in many jurisdictions, including the United States, France, Germany, the Netherlands, and many CEE countries.²³

1. Theoretical Explanation and Rationale

A tax exemption for income from economic activities which are related to public benefit purposes makes a great deal of theoretical

sense. Often the most effective way for an NPO to achieve its purposes is to pursue them through economic means. For example, NPOs which assist certain disadvantaged groups within society would find it natural to produce and/or distribute products which serve that group (like medical devices for people with disabilities). NPOs supporting cultural causes often publish informational materials or charge admission to cultural events. Such activities have merit from a public relations standpoint, and are seen as a logical extension of the goals of the NPO by the citizens and government alike. As long as the public benefit goals remain the principle purpose of the NPO, and as long as the income is not improperly distributed, there is every justification for supporting related activities with tax preferences.

In granting such tax exemptions, governments not only provide additional revenue to NPOs, they also provide incentives and send signals for NPOs to engage in certain forms of behavior. The traditional explanation for the prevalence of this practice is that by providing tax exemptions, governments are trying to subsidize certain activities of certain NPOs.²⁴ This subsidy is justified, many argue, because NPOs often perform essential services that would otherwise have to be performed by the government, and which might be under-supplied without a tax exemption. Additionally, the not-for-profit sector is often able to identify such needs more quickly and meet them more efficiently than governmental bureaucracies.²⁵ While this argument can be used to justify any governmental support for NPOs, the case is much more persuasive when it concerns activities which are related to public benefit purposes.

The "relatedness" rule requires NPOs to focus the majority of their activities on their public benefit purposes, thus reducing the incentive to undertake economic activities merely because they yield high profits. In addition, tax preferences are only provided for publicly beneficial activities.²⁶ For these activities, which are deemed particularly worthy of support by society, claims of unfair competition by for-profit organizations might deserve a less sympathetic hearing.

2. Analytical Criteria

(a) Simplicity or Complexity of Administration: Unfortunately, it is often difficult to distinguish "related" economic activities from those which are "unrelated," and hence this rule is often complicated to administer.²⁷ While the general parameters of the necessary relationship are clear, making many cases easy to resolve, the absence of specific criteria makes borderline cases very

challenging. For example, if a museum opens a shop on its premises to sell books about or copies of works in its collection, this is clearly related to the purposes of the museum and should not give rise to taxable income. However, what if the museum opens a retail store somewhere else which sells materials about art and culture in general? Geographic location can be important, since a coffee shop on the museum premises would be seen as a natural step to enable visitors to obtain refreshments, while such an establishment on the other side of town should clearly be considered an unrelated activity. The problematical nature of applying the concept of "relatedness" is demonstrated by the fact that it tends not to result in the collection of much tax revenue.²⁸

Therefore, it is difficult to draft laws and/or regulations which codify adequately the concept of "relatedness." Guiding principles must often be established on a case-by-case basis. After a body of decisions or norms concerning application of the rule exists, this is likely to be a less serious problem. But for countries in a state of transition, where guidelines for the not-for-profit sector need to be established, the concept of "relatedness" creates a degree of uncertainty concerning the tax treatment of income. This might needlessly deter NPOs from certain types of activities, or subject them to arbitrary administrative responses.

(b) Effects on Revenue Collection: The experience of countries taking this approach suggests that the above-mentioned administrative difficulties tend to result in greater revenue loss than it should, and generally less revenue than universal taxation of all economic activities. Nonetheless, this approach does tax "unrelated" activities which could be exempt under the "destination of income" test. Careful drafting and application of a "relatedness" concept can limit the loss of tax revenue.

(c) Effects on Commercial Sector: This approach, at least theoretically, provides NPOs with no tax advantages over for-profit organizations in "unrelated" fields, thereby ameliorating concerns about unfair competition. Basically, there is little incentive for NPOs to become involved in activities which are not "related" to their public benefit purposes (unless there is significant after-tax profit to be made, in which case the for-profit sector will become involved and compete on equal footing). Also, "related" activities are often naturally within the jurisdiction of the NPO, and may be of little commercial interest to the for-profit sector. In addition, it is also possible to cap the amount of "related" income subject to tax to reduce concerns that these ambiguities might be exploited and abused.

(d) Effects on the Development of the NPO Sector: This approach creates incentives for NPOs to engage in economic activities related to the organizations public benefit goals. Thus, this approach promotes activities considered to be in the public benefit and generally worthy of support. This approach also allows NPOs to generate funds from economic activities. However, this approach does provide less funds than the "destination of income" rule.

(e) Practical Implementation Issues: As discussed above, the primary task associated with this approach is defining "related" and "unrelated" activities. A country survey will be illustrative. Bulgaria permits NPOs to engage only in "related" economic activities, requiring that they directly support public benefit goals other than by generating income. In France, the economic activity must contribute directly to accomplishing the purposes of the association to qualify as "related."²⁹ In the United States, it is the tax authorities who determine whether the activity is "substantially related" to the public benefit purposes.³⁰ To meet this test, the activity must be causally related to the NPOs public benefit purpose, and "contribute importantly" to it.³¹ Unfortunately, it is difficult to apply these general standards into administrable and coherent practice.

To avoid some of the difficulties inherent in applying a definition of "related" activities, some laws include an illustrative list. Hungary has followed this approach, providing clearer guidance to NPOs and government officials. A single list may apply to all public benefit NPOs, or there may be separate lists for different types of organizations.³² It is common to include a "catch-all" provision, allowing NPOs to pursue all other public benefit activities without taxation.

One approach with particular merit is to pass a law covering the basic provisions of "relatedness," but leave the task of preparing and enforcing precise definitions and practices to regulations or decrees.³³ This guidance may take the form of a list of exempt activities, specific instructions, and/or explanations of examples. Any listing of exempt activities should contain a "catch-all" provision, to highlight its illustrative, rather than exhaustive, nature.³⁴ One practical possibility is to form a joint government-NPO committee to help prepare this list for eventual promulgation. Moreover, guidance provided by the regulations will improve over time, as tax officials and sector representatives gain more experience, and as a body of instructive decisions which may have value at least as persuasive precedent develops. In addition, to protect against uncertainty, some countries permit NPOs to obtain

an administrative ruling in advance from the authorities indicating how income will be treated.³⁵

VI. Conclusion

As the countries of CEE and NIS study the subject of economic activities undertaken by NPOs, the experience and practices of other countries around the world need to be considered. Virtually all democratic countries have a vibrant not-for-profit sector, and at least allow NPOs to engage in economic activities of certain kinds. Once this basic principle is accepted, the principal issue is taxation.³⁶

Three general approaches to the taxation of income generated by the economic activities of NPOs have been presented and analyzed. They are: (1) taxing all such income, (2) exempting from taxation all income which is devoted to the public benefit purposes of the NPO, known as the "destination of income" rule, and (3) exempting from taxation all income from economic activities which are "related" to the public benefit purposes of the NPO. The results of this analysis categorized along the lines of each of the five criteria identified are summarized below.

1. Simplicity or Complexity of Administration

Taxing all economic activity is the simplest approach to administer. Once economic activities are defined, NPOs are treated the same way as for-profit organizations. The "destination of income" rule is slightly more complex to administer. The main difficulty is establishing and enforcing criteria for what constitutes an expenditure in furtherance of public benefit purposes. A "relatedness" test is the most complicated to apply, since the necessary connection between the economic activity and the public benefit purposes is difficult to specify.

2. Effects on Revenue Collection

The largest potential tax base is produced by the first approach, since it subjects the greatest scope of NPO income to taxation, although empirically it is unclear how much tax would in fact be collected. In its purest form, the "destination of income" rule has the lowest potential to produce tax revenue, because all income from whatever source is free from tax if it is applied to performance of public benefit purposes. In practice, however, many countries impose limits upon the amount of income that is exempt under the "destination of income" rule, thus limiting potential losses to the revenue base. The "relatedness" test also potentially reduces the size of the tax base, but probably less than the "destination of

income" test. This is because it has the effect of channeling NPO economic activity into specific areas often associated with public benefit and because it provides tax benefits only for these "related" activities.

3. Effects on Commercial Sector

The taxation of all NPO income from economic activities is most favorable for the commercial sector, since there is no possibility of unfair or prejudicial competition. The "destination of income" rule, in its purest form, does nothing to prevent unfair competition, since the nature of the use of income may give NPOs a tax advantage which their for-profit competitors do not share. Naturally, a limit on this benefit reduces the comparative advantage for NPOs. The "relatedness" test minimizes unfair competition by encouraging NPOs to focus upon certain activities most traditionally associated with public benefit, and placing them on equal status with for-profit enterprises when they venture into activities purely on the basis of profit motive.

4. Effects on the Development of the NPO Sector

The taxation of all revenue reduces resources for the not-for-profit sector, essentially transferring money away from NPOs and into the governmental sector. It is generally accepted that NPOs devoted to public benefit purposes, if not eligible for state subsidies, should at the very least not be required to transfer resources to the state (in the same fashion as for-profit enterprises). Taxing all NPO income from economic activities eliminates the incentive to engage in public benefit activities, and is most unfavorable to the not-for-profit sector. At the very least, such taxes should be at a lower, preferential rate compared to for-profit enterprises.

The "destination of income" rule provides the greatest potential revenue to NPOs, since virtually any income can be made tax-exempt. This benefit will vary with the level of any limit which might be imposed. The "relatedness" test is less favorable to NPOs, because activities which are undertaken purely to obtain revenue enjoy no tax exemption. However, the "relatedness" test still provides significant tax benefits for NPOs, particularly when they focus on activities associated with their public benefit purposes. Moreover, the "relatedness" channels NPO economic activities into more socially useful directions than the "destination of income" test which encourages NPOs to engage in economic activities with the greatest potential return.

5. Practical Implementation Concerns

Taxing all income from economic activities is the easiest approach to implement, since there are uniform rules for NPOs and for-profit organizations alike. The "destination of income" rule uses a mechanical approach which is relatively easy to administer, although it is necessary to define what constitutes an expenditure in furtherance of public benefit purposes, and supervise the actual use of profits. Nonetheless, it is still necessary to monitor NPOs and their use of funds, and this "policing" function may prove to be administratively difficult. Moreover, this approach creates a greater potential for abuse by unscrupulous individuals seeking to use NPOs as vehicles for tax evasion. The "relatedness" test is relatively difficult to implement, since a precise definition and application of this concept is elusive, and tends to work best when developed over time through administrative practice. On the other hand, this approach is most likely to give NPOs an incentive to focus on the types of activities NPOs that benefit the public.

In this paper, no particular approach is being advocated above another. Rather, this paper seeks to provide an analytical framework within which policymakers can weigh the benefits and limitations of different approaches, given the conditions of their particular countries. Moreover, it may be possible to combine approaches, for example, exempting all income from related sources as well as a certain amount of unrelated income. Ultimately, the choice depends upon the social, economic, political and legal traditions and conditions in each country. Hopefully this brief exposition of issues will contribute to the effort to develop appropriate, informed rules governing the economic activities of NPOs.

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1. The term "not-for-profit organizations" is used in a broad sense to encompass organizations that are known variously as charities, nonprofit organizations, non-governmental organizations (NGOs), private voluntary organizations (PVOs), civil society organizations (CSOs), etc.
 2. The Value Added Tax (VAT) implications of economic activities are discussed in a paper by Ole Gejms-Onstad of the Norwegian School of Management, which is presented as an appendix to this paper.
 3. Many of the same rules apply for the taxation of "economic" or "commercial" activities when they are undertaken by mutual benefit NPOs. For simplification, this paper will only address public benefit NPOs.
 4. These issues are treated in greater detail in ICNLs accompanying Issue Paper on Public Benefit Status of NPOs.
 5. Reasonable compensation for services rendered to an organization which are necessary for the accomplishment of its charitable purposes and are appropriate in scope will not be

prohibited by this assumption, because such payments are not considered to have been made out of net earnings.

6. We understand that some aggressive tax authorities in the CEE have attempted to characterize grant revenues as taxable "fees for services." Under US law, for a receipt to be considered a "grant," the contractual relationship between the donor and the donee ordinarily requires that any benefits to the grantor are purely incidental and that charitable beneficiaries are the primary targets of the funding.
7. These four terms are used interchangeably to describe any transfer of property to an NPO in return for which the transferor receives nothing of substantial value. Hereafter, the term "donation" will be used.
8. Passive income includes earnings from "royalties, rents, dividends, interest, annuities, and, to the extent of any gain, sales or exchanges of stock or securities." JACOB MERTENS, JR., *MERTENS LAW OF FEDERAL INCOME TAXATION*, 41B:120 (1995). Some countries choose to tax passive income, either at reduced or full rates, while others choose not to tax it at all.
9. BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS*, 12.3 (1992); Trevor A. Brown, *Note: Religious Not-for-profits and the Commercial Manner Test*, 99 Yale L.J. 1631, 1641 (1990). See also James Bennett and Gabriel Rudney, *A Commerciality Test to Resolve the Commercial Not-for-profit Issue*, Tax Notes, 1095 (September 14, 1987).
10. In Croatia, NPOs that sell goods or services only to members of the NPO are definitionally considered not to be engaging in "economic" activity.
11. *SELECT LEGISLATIVE TEXTS AND COMMENTARIES ON CENTRAL AND EAST EUROPEAN NOT-FOR-PROFIT LAW*, edited by Douglas Rutzen, published by ICNL, the European Foundation Centre Orpheus Programme, and the Union of Bulgarian Foundations, Romania Country Report, prepared by Lucian Mihai.
12. In England it is necessary to establish a subsidiary to conduct economic and commercial activities. This is also the case under the recently passed Law on Foundations in Lithuania.
13. These two approaches illustrate, but do not exhaust the list of possible options. In Canada, for example, a relatedness test is used to determine not only tax issues but also whether an NPO may engage in the economic activity at all. In addition, some experts in the region have suggested that strict disclosure rules concerning economic activities would help ensure that NPOs do not engage in excessive or inappropriate economic activities, but it is unclear whether public scrutiny would actually achieve these results.
14. Law Governing Profit Tax on Corporate Persons of 15 February 1992, Art. 17, as amended 1995.
15. *Select Legislative Texts and Commentaries on Central and East European Not-for-Profit Law*, Czech Republic Country Report, Page 9, prepared by Petr Pajas.
16. See, e.g., Ole Gejms-Onstad, *The Taxation of Unrelated Business Income of Nonprofit Organizations*, 9-15 [on file with ICNL].
17. John Copeland & Gabriel Rudney, *Business Income of Not-for-profits and Competitive Advantage*, Tax Notes, 747, 749 (1986) (discussing pre-tax comparative advantages of NPOs).
18. Additionally, proponents argue that NPOs enjoy competitive advantages over for-profit organizations prior to tax exemption, which eliminate the need for further subsidization. First, it may be easier for NPOs to market their goods and services to the public as a result of the perception that they offer higher quality and lower prices than their profit-seeking counterparts. Managers of NPOs are sometimes perceived as having a fiduciary relationship with their customers. Second, NPOs often have lower labor costs, particularly if they use volunteers. Third, while for-profit organizations receive income only from the sale of goods and services, NPOs may also receive government funds and private donations. However, as previously noted, these sources of income are limited in many CEE and NIS countries, and in general these arguments carry less weight in countries in

- a state of transition. (In contrast, some commentators assert that this tax regime actually disadvantages NPOs vis-à-vis businesses because businesses are able to reinvest in ways that give rise to deductions which reduce net profits and tax, whereas NPOs, which make distributions for net profits for public benefit purposes, are often not able to obtain these deductions and are effectively taxed more heavily.)
19. In some instances, there is a time limit within which net profits must be spent on public benefit purposes in order to avoid taxation.. However, oversight can be problematical because money is fungible. In addition, such limitations make it difficult to build an endowment, since money must be spent during the prescribed period, regardless of whether this is efficient. Finally, such a rule can complicate multi-year agreements and contracts. For these reasons, Poland eliminated its two-year time limitation upon the destination of income exemption in 1995.
 20. *SELECT LEGISLATIVE TEXTS AND COMMENTARIES ON CENTRAL AND EAST EUROPEAN NOT-FOR-PROFIT LAW*, Croatia Country Report, Page 6, prepared by Gojko Bezovan.
 21. Pajas, *supra* note 13, at 9. The Czech Republic taxes profits derived from related commercial activities, but exempts up to 3 million CZK, or 30% of the organizations tax base, whichever is less, if those profits are used to pay expenses for public benefit activities. This approach combines the "destination of income" rule with a requirement that the economic activity be related to public benefit purposes, which can become complicated to administer.
 22. See note 17 *supra*.
 23. Some countries, including Bulgaria, and Canada, employ a form of the "relatedness" test to determine which commercial and economic activities an NPO may conduct. For example, Bulgarian NPOs may engage in "auxiliary economic activities" if they (1) are limited in scope when compared to the organizations activities as a whole, and (2) directly support the purposes of the organization other than by generating funds.
 24. For an analysis of the importance of exemptions for subsidizing organizations deemed to be valuable by the public, see Mark A. Hall & John D. Colombo, *The Charitable Status of Not-for-profit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307 (1991).
 25. See *The Role and Purpose of the Not-for-Profit Sector* by Leon Irish, delivered at the Regulating Civil Society Conference in Sinaia, Romania, May 1994 [on file with ICNL].
 26. Even without a tax incentive to enter "related" fields, NPOs may choose this course because they are familiar with the market, because they already have useful personal contacts and physical facilities, and because this is what their constituents expect.
 27. Because of these problems, "relatedness" concepts are often incorrectly handled by local tax inspectors -- they are inclined to look only at the nature of the activities and not the public benefit purposes of the organization.
 28. See Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STANFORD L. REV. 1017 (1982).
 29. That is, a direct link must exist between the statutory activity and the commercial activity. In addition, for the commercial activity to be tax-exempt under French law, (1) the administration of the association must uphold the non-distribution constraint, (2) the association must not systematically strive for the generation of profit, (3) profits must be used for the purposes stated in the organizations statute, and (4) the commercial activity must reveal a certain social utility by covering needs which are not sufficiently covered by the local commercial market.
 30. I.R.C. 513(a) (1996). In addition, generating funds which can be used for public benefit purposes is not sufficient to make an activity "related." Otherwise, this would be the same as the "destination of income" approach. Instead, there must be a "substantial" or "causal" connection between the public benefit purposes and the economic activity. The activity should in and of itself support the goals of the NPO, or be intertwined with them.

In the absence of such a connection, the activity is "unrelated," and the income should be subject to tax.

31. Treas. Reg. 1.513-1(d)(2) (1987). See Carol S. Niccolls et al., *Unrelated Business Income Tax and Unfair Competition: Current Status of the Law*, 15 J.C. & U.L. 249 (1989).
 32. Two lists of public benefit activities exist in Hungary. List A applies to associations and foundations. List B applies to public benefit companies. *SELECT LEGISLATIVE TEXTS AND COMMENTARIES ON CENTRAL AND EAST EUROPEAN NOT-FOR-PROFIT LAW*, Hungary Country Report, Page 12, prepared by Gábor Györffy.
 33. Since it is much easier for the government to change a regulation than to amend a law, it is prudent to include the list in a regulation. The government will then be able to make modifications more expeditiously, without engaging the legislative process.
 34. Of course, the list is definitionally too restrictive and the catch-all provision (if meaningful) in some sense vitiates the need for a list. Nonetheless, the list provides some guidance to implementers, thus promoting more cogent decision-making.
 35. In the United States, this is called a private letter ruling.
 36. Other related subjects concerning NPO finances, such as government subsidies, privatization, and procurement rules, are beyond the scope of this paper.
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