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The Fiscal Framework for Corporate Philanthropy in CEE and NIS

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Introduction

Corporate philanthropy is only one aspect of the broader concept of "corporate citizenship." Corporate citizenship is the deliberate engagement of businesses in their respective communities through various actions, including *pro bono* contributions of goods and services, training for employees and students, renovation of buildings, and reduced-fee or free health, education, and social services. Philanthropy is an important--but by no means exclusive--way that businesses can become engaged to improve surrounding communities.

Corporations engage in philanthropic activity for a variety of reasons. Typically, the tax incentives provided to donors are not a primary motivation. Nonetheless, a favorable fiscal framework is fundamental to promoting deeper corporate involvement--and corporate philanthropy--with communities and with civil society. A recent study by *The Independent Sector* in the United States illustrates a strong link between tax policy and charitable giving. This study shows that the ability to claim a tax deduction for charitable contributions plays a major role in donor decisions--at every income level--regarding how much to give.

The fiscal framework can provide tax incentives for corporate donors, either through allowable tax deductions or tax credits, or through innovative means such as Slovakia's "corporate 1% law." The fiscal framework can remove potential obstacles to corporate giving by ensuring that recipients are not taxed for the donations they receive. The legal framework can encourage corporations to establish independent grantmaking entities--usually foundations--which can act to fulfill the corporation's philanthropic goals. This overview will examine these legislative and fiscal trends in Central and Eastern Europe (CEE) and the Newly Independent States (NIS).

Tax Incentives for Corporate Donors

Tax laws in nearly every country in CEE offer some degree of incentive for corporate giving (though very little in Macedonia). Most NIS countries also offer some tax advantages for corporate philanthropy, with the notable exceptions of Azerbaijan, Belarus, Georgia and Russia. Available donor incentives include:

- Tax deductions
- Tax credits
- Tax designation schemes (1% laws).

In both regions, tax deductions are overwhelmingly the most common form of donor incentive. Only in Latvia are companies provided tax credits. To qualify for a tax deduction or credit, the corporate donation must generally go to a legal entity

pursuing some enumerated purpose, such as a health, humanitarian, cultural, educational, scientific, or amateur sports purpose. In some jurisdictions, potential recipients include municipalities (Bulgaria, Slovakia) or individuals and businesses (Kosovo). But in nearly all countries, potential recipients include NGOs--or more precisely, the category of NGOs pursuing designated purposes. The key determining factor for tax incentives is usually the purpose of the donation, not the organizational form of the recipient.

Some countries do, however, link tax incentives to specific organizational forms, such as NGOs or public benefit organizations (PBOs). In Hungary, for example, corporate donors giving to PBOs may deduct up to 20% of pre-tax profits; corporate donors giving to prominent PBOs may deduct 150% of the donation up to 20% of pre-tax profits. In Latvia, recipient organizations must be NGOs appearing on a Ministry of Finance-approved list, entry onto which is burdensome and must be renewed annually.

Macedonia also limits the availability of tax deductions according to the recipient of the donation, but excludes NGOs from the potential recipients. Instead, tax deductions are granted only where the recipient of the donation is a public organization funded by the state budget--in other words, public institutions--or the Red Cross. A donor may not claim a deduction for a donation to an NGO, regardless of the purposes the donation is supporting.

All countries allowing for deductions limit the benefit to a certain percentage of either gross income (Bosnia, Croatia, Czech Republic, Serbia, and Montenegro) or pre-tax profits (most of the remaining CEE and NIS countries). That percentage generally is set between 0.5% and 10%. Hungary and Lithuania allow for deductions to be made up to 20% and 40% of taxable income, respectively. In Uzbekistan, 100% of the income generated by a commercial subsidiary established by an NGO may be tax-exempt, if that income is transferred to the founding NGO and used to support the NGO's statutory purposes.

One of the more innovative tax incentives in the region in recent years has become known as the "1% Law." Pioneered in Hungary in 1996, the 1% Law allows private individuals to designate 1% of their tax liability to an NGO and 1% to a church. To be entitled to receive 1% contributions, a foundation or association must carry out public benefit activities. State museums and other state cultural institutions are also eligible recipients. Hungary's 1% Law, through which \$15.76 million was designated for NGOs in 2001 alone, has served as a model for similar tax designation legislation now enacted in Slovakia, Lithuania, and most recently, Poland. It is only in Slovakia, however, where both individuals and businesses may participate in the designation system. A company may split its designation amount among several entities.

Two recent advances should be noted. On March 8, 2003, the President of Kyrgyzstan signed the Law on Amendments to the Tax Code, exempting humanitarian aid, grants, charity donations, endowments, and membership and entry fees from income tax. The new tax code provisions increase allowable deductions for local donors from 2% to 5%. As parliamentary deputy K. Karabekov stressed, "Grants to ... people in need are not given now because of gaps in the legislation.... [Amendments to the tax code] would be very important to encourage charitable contributions."

In December 2002, the Bulgarian Parliament enacted tax law amendments benefiting NGOs and donors in Bulgaria. As of January 1, 2003, the amendments reduced the corporate income tax on "donations accounted as expenses" (formerly as much as 25% of the donation) to 15% when made to PBOs registered in the Central Registry, and to 20% when made to other legal entities.

Tax Treatment of Donations and Recipient Organizations

Corporate giving is, of course, also influenced by the tax treatment of the recipient organization. Fortunately, income from grants and donations is typically exempt from tax in countries of CEE and NIS. In some countries (including Bulgaria, Latvia, Lithuania, Poland), a full tax exemption for donations is prescribed only for public benefit organizations, or NGOs engaged in specified public benefit purposes.

Thus, a core issue affecting the development of an appropriate framework for philanthropy is the definition of which NGOs should be considered "public benefit" organizations. The situation in Estonia is illustrative. Currently, the Estonian tax laws provide for a "list" of public benefit type organizations--organizations apply for entry on the list, and once they are listed, they are entitled to certain tax benefits. Entry on the list is determined by the tax authorities, according to the income tax law, which provides that an organization is qualified for the list if it provides charitable support of certain activities (science, culture, education, health care, etc.) in the public interest. The criterion is sufficiently broad that the tax authorities have had difficulty applying it consistently. As a result, some membership-type clubs have obtained status on the list, while research-based organizations, or think tanks, have initially been denied entry. The granting of public benefit status and tax benefits to organizations that do not in fact serve the public benefit undermines the public image of the sector and may frustrate efforts to expand philanthropy.

Public benefit status can be conferred either explicitly, through public benefit legislation, or implicitly, through provisions in various laws that are functional equivalents of the operational provisions of public benefit legislation. Public benefit provisions are contained in the basic NGO laws in Bosnia, Bulgaria, and Romania. Separate legislation on public benefit organizations has been enacted in Hungary (1997) and Poland (2003), and is currently in draft form before the Latvian Parliament. In the NIS, charity laws have been adopted in Armenia, Moldova, Kyrgyzstan, Russia, and the Ukraine, and have been submitted in draft form to the parliaments in Georgia, Tajikistan, and Uzbekistan.

The challenges relating to regulating public benefit organizations are several: what constitutes public benefit activity, who should determine if an NGO qualifies as a PBO, what benefits and obligations attach to public benefit status. In several countries, including Russia, Estonia, and Tajikistan, legal recognition of PBOs (or charities) needs further clarification or elaboration. At the federal level in Russia, the concept of charitable status is not linked to tax benefits; current Tajik legislation does not clearly distinguish between charities and other NGOs. In countries offering limited donor incentives, the clear connection between PBO status and tax benefits can be critical to encourage the growth of philanthropy.

Two recent advances deserve mention. On April 24, 2003, the Polish Parliament adopted the Law on Public Benefit Activity and Volunteerism. Among other features, this new law defines the criteria for public benefit status of Polish

NGOs. Any NGO that meets conditions specified in the law may apply for the status of a public benefit organization. Public benefit status is connected with significant privileges, primarily tax benefits.

Also, the draft of the Law "On Charitable Activity" was approved on the second reading at the Lower Chamber of the Parliament of Tajikistan in February 2003. If enacted, the law would help to improve implementation of the tax code provisions related to tax treatment of charities. The new law would also provide a basis for expanding existing tax benefits to charities in compliance with international good practices. Expanded tax benefits to charities should, in turn, help promote philanthropy.

Establishment of Corporate Foundations

Many businesses seeking to make a long-term impact in a country or a region do so through the creation of corporate foundations. As independent grantmaking entities, often supported by endowments, corporate foundations are a critical example of the long-term dedication of assets to sustain philanthropy. The threshold questions for companies seeking to establish grantmaking foundations relate to establishment, registration, and operation within a given legal system. How easy is it to set up a foundation? Is a minimum start-up capital required? Does the legal framework encourage the maintenance of endowments? Are there management rules or minimum payout requirements? Does the fiscal framework encourage investment activity?

In some countries, such as Croatia, the foundation is not a favored NGO form. The Croatian Law on Funds and Foundations (1995) prescribes burdensome conditions for the establishment of foundations and gives the registration authority (Ministry of Justice) unwarranted discretionary power over the establishment and internal governance of foundations. As a result of the regressive framework, only some 75 foundations have been registered in Croatia to date (compared to more than 20,000 registered associations under the enabling Law on Associations), despite significant potential for the development of an endowment culture.

Countries with a more enabling framework for foundations are wrestling with other problems. There is fear in Slovakia that companies will rush to set up their own foundations to which they can then designate the 1% of their profit tax (under the new 1% Law) in the following year. These newly created foundations, however, may well serve as effective channels to distribute companies' 1% designation and possibly other company funds to Slovak NGOs (as opposed to companies designating the amounts directly). Leading Slovak NGOs and experts are now helping to educate companies on the importance of responsible giving, whether through the creation of these foundations or through other means.

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