



*The International Journal
of Not-for-Profit Law*

**Volume 12, Number 1
November 2009**

A Quarterly Publication of

The International Center for Not-for-Profit Law
1126 16th Street, NW, Suite 400
Washington, DC 20036
(202) 452-8600
www.icnl.org

Publisher

International Center for Not-for-Profit Law
1126 16th Street, NW, Suite 400
Washington, DC 20036
(202) 452-8600
www.icnl.org

Editor: Stephen Bates

Senior Editor: Douglas Rutzen

Contributing Editor: Stephan Klingelhofer

Production Editor: Ivan Gan

The International Journal of Not-for-Profit Law, ISSN 1556-5157, is a forum for the discussion of civil society, philanthropy, nongovernmental organizations, and the law, published quarterly by the International Center for Not-for-Profit Law, www.icnl.org. Based in Washington, D.C., the International Center for Not-for-Profit Law promotes an enabling environment for civil society and public participation around the world. Views expressed here do not necessarily reflect those of the International Center for Not-for-Profit Law, its affiliates, or its funders.

Except where otherwise noted, all contents copyright 2009 by the International Center for Not-for-Profit Law.

The International Journal of Not-for-Profit Law

Volume 12, Number 1
November 2009

Letter from the Editor 4

NGOS IN THE POLITICAL REALM

*Political Activities of NGOs:
International Law and Best Practices*
International Center for Not-for-Profit Law 5

*NGOs: An Antibiotic Against Bureaucracy,
Democracy's Degenerative Illness*
Eduardo Szazi 44

ARTICLES

*Citizen Participation in Mexico
Through Advisory Councils*
Consuelo Castro 52

State Supervision of NGOs in Perú
María Beatriz Parodi Luna 55

*Endowment Funds: New Developments
in the World of Philanthropy in France*
Philippe-Henri Dutheil 66

*Legal Framework for External Supervision
of NGOs in Current Czech Law*
Katerina Ronovska 71

British Charities and Insolvency
Pesh Framjee 78

Letter from the Editor

We begin our twelfth year by examining nongovernmental organizations in the political realm. Our lead article summarizes the laws and best practices related to NGOs' political activities. It's the work of a team of experts assembled by the **International Center for Not-for-Profit Law**. Next, **Eduardo Szazi**, Professor of Law, Getulio Vargas Foundation, Brazil, and a member of ICNL's Advisory Council, considers the NGO as a potential counterweight to official bureaucracy.

This issue also features **Consuelo Castro** evaluating Advisory Councils in Mexico, which help foster relations between government and civil society. The author is Legal Director at the Mexican Center for Philanthropy (CEMEFI), a member of the Technical Advisory Council, and a member of the Advisory Council of ICNL. The next article assesses the role of the state as supervisor of Peruvian NGOs. The author, **María Beatriz Parodi Luna**, is an Attorney; a Partner of BP& MN, Legal Consultants; and also a member of the Advisory Council of ICNL. **Philippe-Henri Dutheil**, chairman of the International Not-for-Profit Organizations Network for Ernst & Young and another member of ICNL's Advisory Council, summarizes the laws governing endowment funds in France. **Katerina Ronovska**, an assistant professor of civil law at the Masaryk University of Brno, Czech Republic, explains the legal framework for external supervision of Czech NGOs. Finally, **Pesh Framjee** explains the rules facing insolvent charities in Britain. The author is the Head of the Unit providing services to Not For Profit Organisations at Horwath Clark Whitehill LLP, as well as Special Adviser to the Charity Finance Directors' Group.

As always, we thank our authors for their incisive and informative articles on some of the most pressing issues confronting civil society.

Stephen Bates
Editor
International Journal of Not-for-Profit Law
sbates@icnl.org

NGOs in the Political Realm

Political Activities of NGOs: International Law and Best Practices

International Center for Not-for-Profit Law¹

I. Introduction

In many countries around the world, government leaders are speaking out against the engagement of non-governmental organizations (NGOs) in “political activities” and thereby seeking to justify legal restrictions imposed on the NGO sector. In recent years we have witnessed restrictive laws and regulations proposed or enacted in several countries including Azerbaijan, Belarus, Ecuador, Ethiopia, Kazakhstan, Uzbekistan, and Venezuela, among others.²

This trend is not new. Since 2005, former Russian President Vladimir Putin has commented on several occasions about how inappropriate it is for NGOs to engage in political activities. Many of these statements were made in conjunction with the drafting and enactment of the Federal Law of the Russian Federation # 18-FZ “On Introducing Amendments to Certain Legislative Acts of the Russian Federation” (“Russian NGO Law”), dated January 10, 2006, which substantially expanded the Russian Government’s authority to audit NGOs, amongst other restrictions on NGOs’ activities. In his statements, Mr. Putin expressed special concern regarding foreign funding of any political activity in Russia, and insisted that any such funding must come under state control:

¹ ICNL is the leading source for information on the legal environment for civil society and public participation. Since 1992, ICNL has served as a resource to civil society leaders, government officials, and the donor community in over 100 countries.

A number of prominent lawyers have contributed to this paper. ICNL would like to thank the following persons for their contributions: Arthur B. C. Drache, CM, QC (Canada); Lindsay Driscoll (UK); Fabrice Supplisson (France); Dr. Michael Ernst-Pörksen (Germany), Nilda Bullain (Hungary), and Rochelle Korman (U.S.). ICNL staff members also contributed to this paper.

This paper is made possible with the generous support of the American people through the United States Agency for International Development (USAID). The contents are the responsibility of the authors and do not necessarily reflect the views of USAID or the United States Government.



Every effort has been made to insure that the information in this paper is current. Nonetheless, the paper may not reflect changes in the laws that have occurred since its compilation. If errors are found, ICNL gladly welcomes notification.

² Moreover, the restrictive trend against civil society and NGOs has gained momentum globally. For more information, please see Catherine Shea and David Moore, *Civil Society Under Threat: Common Legal Barriers and Potential Responses*, USAID 2005 Sustainability Index.

I object categorically to foreign funding of political activity in the Russian Federation. I object to it categorically. Not a single self-respecting country allows that and neither will we.³

The ongoing funding of political activity in Russia from abroad, I think, must be on the state's radar screen, especially if this funding ... comes through the state channels of other countries, and ... organizations operating here and involved in political activity are, in essence, used as foreign policy instruments by other states.⁴

Notably, in June 2009, the newly elected Russian President Medvedev supported amendments to the NGO Law, removing several restrictive provisions, including some aiming to restrict the political activities of NGOs.⁵ Nonetheless, recently proposed legislation in neighboring countries seems to reflect ongoing uncertainty regarding NGO engagement in “political” activities. To cite but two examples from recent months:

- In March 2009, the Kyrgyz Parliament began consideration of the draft Law “On Amendments to Several Legislative Acts of the Kyrgyz Republic” (“Kyrgyz draft NGO Law”). The Kyrgyz draft NGO Law sought to prohibit NGOs from engaging in any “political activities.” The term was not defined, and, therefore, NGOs were concerned that it would be interpreted broadly so as to prohibit an individual from participating in a town hall meeting on behalf of an NGO, or even bringing to the public’s attention alleged corruption by a government official. Fortunately, just prior to the draft being scheduled for consideration by Parliament, the Kyrgyz President withdrew support of the draft Law, and we hope that it will eventually be withdrawn from the Parliament’s agenda.⁶
- In June 2009, the Azerbaijani Government introduced amendments to the Law on Non-governmental Organizations (Public Associations and Foundations) (hereinafter, “Azerbaijani NGO Law”).⁷ The amendments to the Azerbaijani NGO Law stated that “the charters of NGOs shall not contain functions which belong to state or municipal authorities, allow interference into the activities of these authorities, or provide for engaging in state control or supervision,” effectively preventing NGOs from performing watchdog functions over public offices, criticizing the government, or performing other “political activities.”

Of course, many NGOs operating in the former Soviet Union are troubled by governmental efforts to restrict their activities, because they fear that these restrictions might prevent them from implementing their core statutory activities, such as representing the interests of members, participating in public debates on various issues, or serving as watchdogs over the government’s actions. As a result, ICNL has been requested to provide comparative information on the issue of NGO engagement in political activities. We have reached out to some of the

³ Robert McMahon, *Russia: Putin ‘Foreign Funding’ Remarks Draw Civil Society Concerns*, Radio Free Europe / Radio Liberty, July 21, 2005.

⁴ *Putin Stands by Tough NGO Bill*, <http://www.1st-russian-translation.co.uk/russian-translation-news-271105.html>

⁵ In June 2009, the State Duma adopted amendments to Russian Federal Law No. 7-FZ of January 12, 1996, “On Non-Commercial Organizations” (NGO Law),⁵ which will come into force on August 1, 2009.

⁶ <http://kg.akipress.org/news:74931>

⁷ The NGO Law was adopted on June 13, 2000 and subsequently amended.

world's leading experts to assemble a compilation of reports on how the legal framework in other countries addresses the question of NGO engagement in political/legislative/advocacy activity. The goal of the paper is to enable our colleagues and partners to analyze regulatory restrictions, whether proposed or in force, against a broader background of international practice.

This paper consists of five sections. Following Section I (Introduction), Section II contains a brief overview of international law and its applicability to the issue. Section III presents a comparative perspective on regulatory approaches toward political activities, in summary form. Section IV then contains a series of brief reports on NGO engagement in political activities from six countries: Canada, England and Wales, France, Germany, Hungary, and the United States – all countries with recognized democratic traditions, but with very different legal traditions and diverse regulatory approaches towards NGOs and their activities. Section V concludes by identifying some common regulatory approaches or “best practices” relating to this sphere, and based on Anglo-American-European practice.

II. International Law

The Universal Declaration of Human Rights⁸, a U.N. General Assembly resolution, and the International Covenant on Civil and Political Rights (ICCPR)⁹, a treaty ratified by more than 150 countries around the world, recognize that all individuals possess the rights to freedom of opinion and expression, and freedom of peaceful assembly and association. According to these widely respected international pronouncements, both rights may be limited in conformance with the “interests of national security or public safety, public order, the protection of public health or morals, or the protection of the rights and freedoms of others”¹⁰ in a democratic society.

The European Convention on Human Rights and Fundamental Freedoms (ECHR), which is applicable to all members of the Council of Europe – including Russia, Ukraine, Moldova, Georgia, Azerbaijan, and Armenia – also protects the freedoms of expression (Article 10) and association (Article 11). The European Court of Human Rights, in considering the scope of Article 11, has expressly held that Article 11 applies to individuals and their right to form political parties and associations, and that once formed, these organizations are deserving of the Convention's protections.¹¹ Like the ICCPR, the European Convention also defines a limited list of legitimate government interests that may justify restrictions on fundamental freedoms. A government that restricts the exercise of these freedoms must demonstrate why interference is ‘necessary in a democratic society’ to achieve legitimate state interests, which include the interests of national security or public safety, the prevention of disorder or crime, the protection of public health or morals, or the protection of the rights and freedoms of others.¹²

⁸ The Universal Declaration was adopted and proclaimed by the U.N. General Assembly in 1948.

⁹ The ICCPR entered into force in 1976.

¹⁰ ICCPR, Article 22(2).

¹¹ United Communist Party of Turkey and Others v. Turkey, European Court H.R. 133/1996/752/951 (30 January 1998).

¹² ECHR, Article 11(2): “No restrictions shall be placed on the exercise of these rights other than such as are prescribed by law and are necessary in a democratic society in the interests of national security or public safety, for the prevention of disorder or crime, for the protection of public health or morals or for the protection of the rights and freedoms of others. This article shall not prevent the imposition of lawful restrictions on the exercise of these rights by members of the armed forces, of the police or of the administration of the State.”

Restrictions imposed against NGOs for reasons of limiting “political activity” are not clearly and necessarily justified as supporting a legitimate government interest under the ICCPR or ECHR. If defined to include criticism of governmental policy, for example, then the restrictions on political activity would likely be impossible to justify. The freedom of expression articles include the right to make opinions known and to join public debate, and to provide and receive information; it protects not only inoffensive ideas but also those that “offend, shock and disturb”, since pluralism is essential for “democratic society.”¹³ The issue turns, of course, on what is meant by “political activity.” Vague, ill-defined restrictions against political activity, however, are almost certainly in violation of international law.

III. Political Activities: A Comparative Perspective

The term “political activity” is subject to multiple interpretations and meanings. In the broadest sense, most NGO activities have implications for public policy. Depending on the context, “political activity” could be defined narrowly or broadly to include supporting or opposing candidates for public office, supporting particular political parties, lobbying for or against specific laws, engaging in public advocacy, pursuing interest-oriented litigation, or engaging in policy debate on virtually any issue.

Restrictions on political activities of NGOs depend to a certain extent on the *system* of law in each country. Countries with a **common-law** tradition tend to classify NGOs on the basis of charitable or public benefit purposes. For those NGOs classified as charitable, common-law countries tend to restrict their ability to engage in public policy or political activities because such activities are perceived to be inherently partisan, and thus in actual or potential conflict with the public benefit purposes of the NGO. Furthermore, public policy activities should not be improperly subsidized so that they undermine the justification for tax and other related benefits. Where public benefit is not the primary purpose of the NGO, common-law countries tend to be less restrictive.

In **England & Wales**, for example, a charity can never be formed for the primary purpose of engaging in political activities and can never support a political party or candidate. A charity may, however, engage in some political activities (such as lobbying activities), if the activities relate to the charity’s specific purposes or to the well-being of the sector generally, and if these political activities are not the main reason for its existence. Other NGOs (that is, non-charitable NGOs) are free to engage in political activities. **Canada** and **Ireland** have both adopted similar regulatory approaches. Limits on political activities apply only to charities (and *not* to non-charitable NGOs). In the case of Canada, a charity may engage in political activities, provided that they are “ancillary and incidental” to the organization’s charitable activities and “do not include the direct or indirect support of, or opposition to, any political party or candidate for public office.” In Ireland, charities may undertake ancillary political activities, such as advocacy or consultation on law reform, in order to further their primary charitable purpose.

In the **United States**, the scope of permissible public policy activities for NGOs is directly related to their statutory purposes and actual activities. Charitable organizations falling under the reach of the Internal Revenue Code 501(c)(3) cannot dedicate a substantial part of their activities to carrying on propaganda or otherwise attempting to influence legislation, and are prohibited from becoming involved in political campaigns for public office. Within the

¹³ Socialist Party and Others v. Turkey, European Court H.R. 20/1997/804/1007 (25 May 1998).

boundaries of this limitation, 501(c)(3) charities are allowed to spend a limited amount of money to influence legislation, and can always publicize the results of nonpartisan research or provide technical assistance to legislative bodies. Other categories of NGOs, such as civic leagues or business leagues, regulated through other I.R.C. sections, face no such limitations.

In sum, in most common-law countries, the boundaries of allowable “**political activities**” are defined based on the same general regulatory approach. First, the restrictions apply only to charities or tax-exempt organizations (and not to all categories of NGOs). Second, certain kinds of activities, including the direct or indirect support of, or opposition to, any political party or candidate for public office, are strictly prohibited. Third, other kinds of activities, perhaps better phrased as public policy activities, which include attempting to influence legislation or lobbying, are permissible within certain limits (e.g., must be ancillary to the organizational purposes, must not be a substantial part of the activities, etc.). The precise contours of what is permissible and what is not can be controversial within any national context. For example, the courts in Canada have consistently expanded the notion of what is meant by the term “political activities,” making it difficult to distinguish between education, advocacy, and political statements.¹⁴ Moreover, in the United States, the Internal Revenue Service’s (IRS) approach to enforcing the ban on partisan activities by charities and religious organizations has raised serious questions about the agency’s interpretation of the law.¹⁵

Civil law countries typically follow a more permissive regulatory approach regarding political activities. As a general rule, there are no specific provisions regarding political activities of NGOs in the civil codes. Countries including France, Belgium, Holland, Finland, Italy, Spain, Germany, Switzerland, and Denmark place no restraints upon the public policy activities of NGOs. In fact, some civil law countries actively encourage NGOs’ political activities. In **Belgium**, for example, there is an explicit right entitled “droit de critique” (right to criticize) which permits associations to use all legal means to defend interests and ideas of organizational objectives. Political parties in **Germany** set up foundations specifically for the purpose of channeling resources into partisan activities. And in **Switzerland**, associations mobilize and represent citizens in the political decision-making process.

Against the background of this permissive approach, **restrictions** are sometimes imposed through the tax or administrative law to limit the scope of political activities, especially where the NGO is pursuing public benefit or tax-privileged purposes. In **Germany**, for example, tax-privileged purposes do not include political activities. Tax-exempted organizations may not act as direct supporters of political parties; they are not allowed to support or campaign for political parties or their political representatives.¹⁶ In **France**, while nothing in the codified law prevents a public benefit organization (public utility association or public utility foundation) from engaging in political activities, a decision of the *Conseil d’Etat* clarifies that organizations with a primarily political purpose, such as engaging primarily in political advocacy, cannot be recognized as public benefit organizations.

¹⁴ See <http://www.usig.org/countryinfo/canada.asp>

¹⁵ Kathryn Clabby, *Overcaution and Confusion: The Impact of Ambiguous IRS Regulation of Political Activities by Charities and the Potential for Change*, November 2007, <http://www.ombwatch.org/files/npadv/paci2rpt.pdf>

¹⁶ Even for tax-privileged NGOs in Germany, a certain amount of influencing public opinion is permissible. Thus, German law permits considerable purpose-related advocacy and lobbying.

In the **new EU Member States**, the regulatory framework for NGOs and political activities is similarly permissive, with restrictions typically linked either to direct financing of political parties, or applicable only to those NGOs receiving state support. **Poland** presents perhaps the most permissive framework: Polish law explicitly gives associations the right to engage in almost any political activity, even participation in electoral campaigns (through special elective committees). In **Slovakia**, associations are similarly free to engage in a range of political activities, including endorsing candidates, lobbying, and even contributing to political campaigns; foundations, however, are restricted from financing political parties. In the **Czech Republic**, while associations cannot be founded for political purposes, they can lobby, endorse candidates, provide information and advocate; foundations, as in Slovakia, cannot provide financial support to political parties but can lobby, endorse candidates, provide information, and advocate. In **Hungary**, NGOs are free to lobby, nominate or endorse candidates, and provide information and financial support to political parties. Restrictions arise only for public benefit organizations (that is, those NGOs with public benefit status and preferential tax benefits), which are prohibited from engaging in direct political activity, such as nominating candidates for national elections or funding political parties.

Thus, in the **European civil-law context**, legislation generally recognizes NGOs as key participants in framing and debating issues of public policy, and like individuals, they have the right to speak freely on all matters of public significance, including existing or proposed legislation, and state policy and actions. Likewise, NGOs generally have the right to criticize or endorse state officials and candidates for political office. They also usually have the right to carry out public policy activities, such as education, research, advocacy, and the publication of position papers. In some cases, however, NGOs (or at least certain categories of NGOs, such as foundations or public benefit organizations) are prohibited from engaging in “party political” activities, such as nominating candidates for office, campaigning, or funding parties or political candidates. As compared to common-law countries, therefore, civil law countries take a more permissive approach, restricting NGOs from engaging in only a narrowly defined range of political activities.

IV. Country Reports

NGOs and Political Activity: The Canadian Rules

Arthur B. C. Drache, CM, QC
Drache, LLP
Ottawa, Ontario Canada

The purpose of this paper is to give an overview of Canadian law and administrative practice as they pertain to “political activities” of NGOs in Canada. Even the term political activities is subject to some interpretation in Canada given that many organizations, which view themselves as being “educational,” have in fact been categorized as being involved in what might be called propaganda activities, which in turn falls within the rubric “political.” The tipping point is whether information presented is “balanced,” or whether it puts forward a particular viewpoint.

As is the case in the United Kingdom, the term NGO is not an identifiable legal term but is shorthand for various types of non-commercial organizations. In Canada, as in the U.K., there are two distinct categories of organizations that have to be considered and have very different rules. The first of these is the nonprofit organization and the second is the registered charity.

I shall first set out the definitional differences and then deal with the very different rules that apply to their carrying on political activities.

Nonprofit Organizations

A "nonprofit organization" is exempt from income tax and is defined by paragraph 149(1)(l) of the Income Tax Act (Canada), which reads:

149. (1) No tax is payable under this Part on the taxable income of a person for a period when that person was...

(l) a club, society or association that, in the opinion of the Minister, was not a charity within the meaning assigned by subsection 149.1(1) and that was organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit, no part of the income of which was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder...."

The above definition constitutes virtually the entire legislative tax system for nonprofit organizations. It should be noted that these organizations:

- are not registered in any way by the government under the Income Tax Act and have minimal reporting requirements¹⁷;
- cannot be charitable at common law according to the Minister of National Revenue¹⁸;
- cannot give receipts for donations which provide tax relief to the donors;
- can be funded in any legal way,¹⁹ whether from within Canada or from outside but no registered charity can distribute funds to a nonprofit; and
- membership need not be limited to Canadians nor need the directors be Canadian.²⁰

The definition of a "nonprofit organization" goes on to list various approved nonprofit purposes, but all can be subsumed under the basket clause of "any other purpose except profit." Furthermore, in order to meet the definition of a nonprofit organization in the *Income Tax Act*, the organization must not make any of its income available to its members. This is consistent with the well-known international concept of a "non-distributing organization," a virtual hallmark of NGOs in almost all countries.

¹⁷ For this reason there is no firm estimate of how many such organizations exist in Canada.

¹⁸ An important aspect given that registered charities are much more rigidly regulated.

¹⁹ Obviously, legislation which applies to all Canadians such as those which prohibit money laundering or terrorist financing are applicable to these organizations as well.

²⁰ Certain provinces require a majority of directors be Canadian but this is not the case with federal incorporations or a requirement of the Income Tax Act.

The extremely broad definition means that aside from organizations that are created to make profits, almost any other type of activity engaged in by organization falls under the definition. This extraordinary range encompasses amateur sports clubs, social clubs, literary societies, and professional organizations,²¹ as well as political parties.

In the context of this paper, the rules regarding political activity are extremely simple: there are none. Given that many of these organizations actively lobby for the interests of their members and given that all political parties fall within this category of organization, this is not surprising. Of course, there are laws of general application that may apply, such as the requirements that lobbyists (whether paid by the organization or employees of the organization) must register with a central registry. And when a federal general election is called, there are limits on all persons and organizations (other than the political parties themselves) that deal with campaign financing.

The ability of nonprofits to legally engage in just about any form of lobbying and political activity obviously makes them attractive vehicles for such work. Many groups have created both a nonprofit organization to carry on political activity (bearing in mind getting funding may be difficult²²) and a separate charity that cannot and does not engage in extensive political activity but carries on purely “charitable” work.

Having looked at the nonprofits, we shall now turn to the much more complex issue of political activities and registered charities.

Registered Charities:

The Income Tax Act also provides a specific tax exemption for a “registered charity.” Subsection 248(1) defines a registered charity as “a charitable organization, private foundation, or public foundation ... that has applied to the Minister in prescribed form for registration and that is at that time registered.” Thus, only a charity registered with the Canada Revenue Agency (CRA) is exempt from income tax under this provision.²³ We have previously seen that the other third-sector income tax exemption of general application, the exemption for “nonprofit organizations,” applies only to organizations that in the opinion of the Minister could not be registered as charities.²⁴

The 82,000 registered charities must meet the common-law definition of “charity” as is interpreted by officials; the definition is probably narrower than in the U.K. and is considerably narrower than the definition of a 501(c)(3) organization in the United States. But as in the U.K., a charity cannot have a political purpose as its main focus.

²¹ These would include giant membership organizations such as the Canadian Bar Association, the Canadian Manufacturing Association, Chambers of Commerce and other groups whose main purpose is to work for the betterment of a relatively small group.

²² In the context of professional and trade organizations, this usually is not a problem because members can claim tax relief for payments as “business expenses”.

²³ The CRA has a web site found at <http://www.cra-arc.gc.ca/tx/chrts/menu-eng.html> which contains an enormous amount of data on all aspects of charity regulation in Canada.

²⁴ In some cases, those creating the organizations “taint” the objects with an overtly non-charitable provision (such as a political/lobbying clause) to ensure that it could not be viewed as a charity.

The most important aspect of getting registered as a charity in Canada is that the registration allows the charity to issue receipts for donations, which are needed to generate tax credits (deductions in the case of corporations) to donors. Given that Canada has one of the most generous levels of tax relief for charitable donations in the world, this ability to issue receipts is the driving force for most charitable registrations.

Interestingly, while a Canadian charity can receive donations from any source including foreign individuals, corporations, and NGOs, it need not issue tax receipts to non-residents²⁵ and, in terms of annual payout requirements by charities²⁶, such donations are not factored in. This means that foreign donations offer advantages to Canadian charities that are not available for domestic donations.

The *quid pro quo* of being able to give tax relief for donations is a highly regulated regime. The requirements include:

- filing annual returns which are made available to the public;
- meeting minimum annual payouts or expenditures on charitable activities; and,
- being subject to audit to ensure that the charity's activities continue to meet the definitional requirement.

It is not the purpose of this paper to look at the Canadian charitable sector in any detail, but under this last point, one of the most common purposes of charity audits is to ensure that the organizations are not involved in inappropriate political activity. If they are found to be “political,” charitable status can be revoked and the assets distributed to other charities.

The question of what is political and what activities are acceptable or not acceptable has been a problem for decades. While on the face of it, the definition of a “registered charity” requires that all its resources be devoted to charitable activity, in fact there has always been a recognition that at least some “political” activity had to be allowed. To this end, the Income Tax Act was amended many years ago to allow, within certain constraints, some level of political activity. While the legislation generally distinguishes between charitable organizations and charitable foundations (whether public or private), the rules relating to political activity are the same for all registered charities and for that reason we will simply refer to registered charities.

149.1 (6.2)²⁷ “For the purposes of the definition “charitable organization” in subsection 149.1(1), where an organization devotes substantially all of its resources to charitable activities carried on by it and (a) it devotes part of its resources to political activities, (b) those political activities are ancillary and incidental to its charitable activities, and (c) those political activities do not include the direct or indirect support of, or opposition to, any political party or candidate for public office, the organization shall be considered to be devoting that part of its resources to charitable activities carried on by it.”

The final clause, in conjunction with the overall definition of registered charities which includes the requirement that all its resources be devoted to charitable activities carried on by it,

²⁵ Who by definition could not use the domestic Canadian tax benefits.

²⁶ The annual “disbursement quota”.

²⁷ Substantially the same rules apply to charitable foundations and are found in subsection 149.1(6.1) of the Income Tax Act.

means that to the extent that resources are devoted to “acceptable” political activities, the charity is deemed to be devoting its resources to charitable works. As a general rule of thumb, this provision has been interpreted as meaning that approximately 10% of a charity’s “resources” can be devoted to acceptable political activity.²⁸

The key elements of the provision are the prohibitions on the support of political parties or candidates and the requirement that any qualifying political activity be linked to the organization’s objects. Thus, while a charity which works to preserve the environment might get involved in “green” issues, it could not get involved in a debate on same-sex marriage.

The significance of this provision is that it established that some level and types of political activities could be carried on by charities. However, there has been no case law on the subject and as a consequence, charities have had to discern from CRA pronouncement what would or would not be acceptable. There have been a number of short “rulings.” For example:

The attendance by registered charity officials, in their official capacity, at a fundraising dinner for a politician is not acceptable because it conveys the impression of partisan political activity by a registered charity. Registered charities are not permitted to carry on partisan political activities. Therefore, they cannot devote any resources to such activities.²⁹

Or this one:

A charity can charge fair market rent to a political party for occasional meetings. This, in itself, does not always indicate a charity's support of such a party, especially in rural areas where sometimes a registered charity may have the only hall that can accommodate such meetings.

This support can manifest itself in other ways. The charity could, for example, charge fair market rent to one political party, but be reluctant to rent the premises to all others. Similarly, a frequent and continued association of the charity with the same political party could lead to the conclusion that the charity favours this party to the exclusion of others. For example, where a party's local headquarters are in a building owned by a registered charity.

While renting premises to a political party at fair market value is not necessarily prohibited, the issue will depend on the facts of each case. Charities are cautioned against engaging in this form of behaviour to the extent that it could be interpreted not only by the Canada Revenue Agency but also by the public-at-large as a prohibited political activity.”³⁰

In September 2003, the CRA issued CPS-022,³¹ which is the most lengthy and discursive of their pronouncements on the subject of political activity and the balance of this paper will look at the highlights of that document. The examples given of both acceptable and unacceptable

²⁸ The term “resources” is not one which can be quantified by accountants and arguably the provision is too vague to be “legal”. However, since it is viewed as giving relief to charities, it has never been challenged. See however CIL 2003-001 at <http://www.cra-arc.gc.ca/tx/chrts/plcy/cl/2003/cl-001-eng.html> for the CRA’s views.

²⁹ CPC – 001 <http://www.cra-arc.gc.ca/tx/chrts/plcy/cpc/cpc-001-eng.html>

³⁰ CPC-007 <http://www.cra-arc.gc.ca/tx/chrts/plcy/cpc/cpc-007-eng.html>

³¹ <http://www.cra-arc.gc.ca/tx/chrts/plcy/cps/cps-022-eng.html>

activities would answer most if not all of the questions originally posed to be considered in this series of papers.

The Policy Statement announced a major shift in CRA policy with regard to the advocacy activities of charities. The basic thrust of the document is encapsulated in the following passages, which are taken verbatim from CPS-022 but with some editing for length and clarity. The highlighted parts are in fact highlighted in the original.

The Government of Canada recognizes the need to engage the voluntary sector in open, informed, and sustained dialogue in order that the sector may contribute its experience, expertise, knowledge and ideas in developing better public policies and in the design and delivery of programs.

... Through their dedicated delivery of essential programs, many charities have acquired a wealth of knowledge about how government policies affect people's lives. Charities are well placed to study, assess, and comment on those government policies. Canadians benefit from the efforts of charities and the practical, innovative ways they use to resolve complex issues related to delivering social services. Beyond service delivery, their expertise is also a vital source of information for governments to help guide policy decisions. It is therefore essential that charities continue to offer their direct knowledge of social issues to public policy debates.

... When charities choose to contribute to public policy debates, they are required by law to do so in a way that considers certain constraints. A charity cannot be established with the aim of furthering or opposing the interests of a political party, elected representative or candidate for public office. Also a charity cannot be formed to retain, oppose, or change the law, policy or decision of any level of government in Canada or a foreign country. **However, charities may choose to advance their charitable purposes by taking part in political activities if they are connected and subordinate to those purposes.**

The Policy Statement continues to acknowledge the supremacy of the common law in regard to the definition of charity. A charity must have objectives that are exclusively charitable in the common law sense. As with common law, and therefore under the Policy and under the Act, an organization that is established for purely political purposes cannot be a charity. Political purposes include furthering the interests of a particular political party ("partisan politics") and advocating for the retention or change in the law, policy, or decision at any level of Government in Canada or in a foreign country. The Policy Statement advises that CRA will look at an organization's purposes and activities in order to determine whether it is organized exclusively for charitable purposes.

When a charity focuses substantially on one particular charitable activity so that it is no longer subordinate to one of its stated purposes, we may question the legitimacy of the activity at law. This is because when an activity is no longer subordinate to a charity's purposes, it may indicate that the charity is engaging in an activity outside its stated objects, or pursuing an unstated:

- collateral political purpose; or
- non-charitable purpose; or

- charitable purpose.

In such circumstances, rather than just considering the explicit purpose of the activity in question, we will consider all the facts and determine whether it is reasonable to conclude that the charity is focusing substantially on a particular activity for an unstated political purpose.

The Policy Statement recommends that whenever a charity wants to go beyond the purposes permitted in the Act, it establish a “separate and distinct organization that will not be a registered charity”. Where such a body is established, no limitation on its political activities is contemplated under the Act. The charity may not, however, fund that separate organization or make resources available to it for otherwise impermissible political activity.

The Policy Statement divides a charity’s activities into three categories: (a) prohibited, (b) political, and (c) charitable. Under prohibited activities, the document mentions engaging in partisan political activity that is directly or indirectly supporting or opposing any political party or candidate for public office. Where a charity wants to engage in a public awareness campaign, it must be careful not to explicitly connect its views with the views of any political party and its views must be well reasoned. Where it wants to provide information to its supporters or the public on the voting behavior of elected representatives, it must be careful not to single out the voting record of a particular individual or party. These clarifications are helpful.

An activity is presumed to be political if the charity (a) explicitly communicates a call to political action; (b) explicitly communicates to the public that the law, policy, or decision of any level of Government in Canada or foreign country should be retained, opposed, or changed; or (c) explicitly indicates in its materials that the intention of the activity is to incite or organize, to put pressure on an elected representative or public official to retain, oppose, or change the law, policy, or decision of the Government. The Policy Statement provides, in this regard:

A charity may take part in political activities if they are non-partisan and connected and subordinate to the charity’s purposes. We presume an activity to be political if a charity:

- a. explicitly communicates a call to political action (i.e., encourages the public to contact an elected representative or public official and urges them to retain, oppose, or change the law, policy, or decision of any level of government in Canada or a foreign country);
- b. explicitly communicates to the public that the law, policy, or decision of any level of government in Canada or a foreign country should be retained (if the retention of the law, policy or decision is being reconsidered by a government), opposed, or changed; or
- c. explicitly indicates in its materials (whether internal or external) that the intention of the activity is to incite, or organize to put pressure on, an elected representative or public official to retain, oppose, or change the law, policy, or decision of any level of government in Canada or a foreign country.”

The Policy Statement contains extensive guidance on what sorts of activities in the context of communication campaigns are charitable per se, and therefore permitted.

When a registered charity seeks to foster public awareness about its work or an issue related to that work, it is presumed to be taking part in charitable activity as long as the activity is connected and subordinate to the charity's purpose. In addition, the activity should be based on a position that is well-reasoned...

Provided a communication with an elected representative or public official is subordinate to a charity's charitable purpose, it will be considered charitable. The representation should:

- relate to an issue that is connected to the charity's purposes;
- be well-reasoned...or based on a well-reasoned position; and,
- not contain information that the charity knows or ought to know is false, inaccurate or misleading.

If the communication, however, concludes with an explicit call to political action, it will be considered to be political, and not charitable.

The policy document contains detailed guidance about education as a charitable purpose and how it differs from public awareness campaigns. Essentially, the Policy adopts the language of the Supreme Court of Canada in *Vancouver Society*. Education, in short, is not biased and is not based on incomplete information or an emotional appeal.

There is an extensive discussion of the provisions of the Act governing the expenditure limits imposed by the concept "substantially all." There is, in this regard, recognition of the difficulties faced by smaller charities.

However, we recognize that this may have a negative impact on smaller charities. In an effort to alleviate this hardship, we will exercise our discretion and not revoke the registration of smaller charities for the excessive use of their resources on political activities as long as they meet the following administrative guidelines:

- Registered charities with **less than \$50,000** annual income in the previous year can devote up to 20% of their resources to political activities in the current year.
- Registered charities whose annual income in the previous year was **between \$50,000 and \$100,000** can devote up to 15% of their resources to political activities in the current year.
- Registered charities whose annual income in the previous year was **between \$100,000 and \$200,000** can devote up to 12% of their resources to political activities in the current year.

The Policy Statement permits the test to be met over a number of years where there are unique one-time conditions causing the charity to expend a larger sum in one year. There is discussion of disbursement quotas, political service contracts, record-keeping requirements, and filing requirements.

Finally, the Policy Statement sets out a number of scenarios in which the rules and administrative views are applied. The discussions are illuminating and we have reproduced in

Appendix A the full set taken from CPS-022. The following is short guide to the topics covered in the Appendix.

The following scenarios illustrate allowable charitable activities:

- Scenario 1 — Distributing the charity's research
- Scenario 2 — Distributing the research report to election candidates
- Scenario 3 — Publishing a research report online
- Scenario 4 — Presenting the research report to a Parliamentary Committee
- Scenario 5 — Giving an interview about the research report
- Scenario 6 — Distributing the research report to all Members of Parliament
- Scenario 7 — Participating in an international policy development working group
- Scenario 8 — Joining a government advisory panel to discuss policy changes

The following scenarios illustrate prohibited activities:

- Scenario 1 — Supporting an election candidate in the charity's newsletter
- Scenario 2 — Distributing leaflets highlighting lack of government support for charity goals
- Scenario 3 — Preparing dinner for campaign organizers of a political party³²
- Scenario 4 — Inviting competing election candidates to speak at separate events

The following scenarios illustrate permitted political activities:

A charity that devotes **substantially all** of its resources to charitable activities may carry on political activities within the allowable limits.

- Scenario 1 — Buying a newspaper advertisement to pressure the government
- Scenario 2 — Organizing a march to Parliament Hill
- Scenario 3 — Organizing a conference to support the charity's opinion
- Scenario 4 — Hiring a communications specialist to arrange a media campaign
- Scenario 5 — Using a mail campaign to urge supporters to contact the government
- Scenario 6 — Organizing a rally on Parliament Hill³³

Recapitulation

As noted at the beginning of this paper, there are two broad categories that NGOs can operate within in Canada. For those that choose to be “nonprofit organizations”, there are virtually no limits on the political activities that can be undertaken.

But for those that qualify as registered charities, they must adhere to significant limitations when it comes to political activity. The rules are primarily administrative but as we

³² Even allowing a representative of a charity to attend (as a representative) a political fundraiser is a prohibited partisan political activity: Charities Policy Commentary CPC-001, February 6, 1990.

³³ The locale of the federal Parliament buildings.

have noted, CPS-022 offers wide-ranging guidance and also shows that within the statutory limits, the Canadian government wants to allow a fair level of political activity.

On a subjective note, I might add that while there was a period where the sector chafed under rules which were not clear, the major problems of determining what can and cannot be done have mostly disappeared in Canada with the publication of CPS-022.

Appendix A

The following are the detailed examples of acceptable and prohibited activities for a registered charity as set of in CPS-022 and referred to in the body of this paper.

14. Examples of activities undertaken by a charity

In the following hypothetical examples, the charity involved is called Healthy Retirement and was formed to promote the health of seniors in Canada. It has received a lot of media attention on its recently released, well-reasoned position on the hazards for seniors of using marked crosswalks. Its findings conclude that a senior is four times more likely to be involved in a fatal accident with a car at a marked crosswalk than at an intersection with a stop sign or a light.

14.1 Charitable activities

The following scenarios outline allowable charitable activities.

14.1.1 Scenario 1 — Distributing the charity's research

Healthy Retirement distributes the results of its research to the media, its members, other charities that specialize in promoting the health and welfare of seniors, the general public, and anyone interested in its findings. It also publishes its report in medical association journals and on its Web site, and highlights its release in a newsletter sent to subscribers. In these cases, all the resources devoted to the research and distribution of the findings are considered resources devoted to charitable activities because:

- the activities are connected and subordinate to the charity's purposes;
- they do not contain a call to political action; and
- they are based on a well-reasoned position.

This is information that seniors can use to improve their safety and that decision-makers can use when deciding where and whether to use crosswalks or other traffic controls when considered in combination with other issues.

14.1.2 Scenario 2 — Distributing the research report to election candidates

Healthy Retirement decides to send its report to all candidates in a municipal election to inform them about the hazard marked crosswalks pose for seniors. This is a charitable activity because it is connected and subordinate to the charity's purpose. In addition, no one candidate is favoured over another.

14.1.3 Scenario 3 — Publishing a research report online

A major finding of the report was that many motorists fail to respect the right-of-way at marked crosswalks. When Healthy Retirement publishes its report online, it highlights this fact

and urges motorists to observe the law. This is still a charitable activity because it is encouraging people to respect the existing law on an issue that relates to its purposes.

14.1.4 Scenario 4 — Presenting the research report to a Parliamentary Committee

The research director of Healthy Retirement presents the charity's findings to a Parliamentary Committee formed to hear representations on whether there should be stiffer penalties in the *Criminal Code* for dangerous operation of a motor vehicle. She ends her representation with a recommendation (based on a well-reasoned position) that a driver failing to observe the pedestrian right-of-way at a marked crosswalk should be automatically subject to a charge of dangerous operation of a motor vehicle, as a deterrent.

Even though the charity explicitly proposed a political solution to the problem, this activity is charitable because it is a communication to an elected official based on a well-reasoned position.

14.1.5 Scenario 5 — Giving an interview about the research report

Following her representation, as the research director of Healthy Retirement is leaving Parliament, she is stopped by the media and interviewed for television and radio about what she said and the report. She outlines her representation and repeats the conclusion that on the basis of the research the charity has done, the charity thinks that the number of pedestrian deaths involving seniors might be reduced if drivers that failed to recognize the right-of-way of pedestrians at marked crosswalks faced stiffer penalties. This interview is not a political activity because the research director did not arrange a media campaign to publicize the charity's conclusion that the law should be changed; she simply explained what she said to the elected representatives.

14.1.6 Scenario 6 — Distributing the research report to all Members of Parliament

A bill is being debated in Parliament. The bill proposes a change to the *Criminal Code* that would allow a driver who fails to observe the pedestrian right-of-way at a marked crosswalk to be charged with dangerous operation of a motor vehicle. Healthy Retirement gives Members of the House, for use in debate, a relevant well-reasoned position regarding how such a charge may encourage drivers to uphold the law and thereby save lives. This is a charitable activity because Healthy Retirement is informing elected representatives about its work on an issue that is connected and subordinate to the charity's purposes and based on a well-reasoned position.

14.1.7 Scenario 7 — Participating in an international policy development working group

The research director of Healthy Retirement is asked to join a working group of the World Health Organization that is gathering together government policy makers, academics, and voluntary sector representatives from around the world to develop a charter to promote the health of senior citizens. Such an activity is connected and subordinate to the charity's purpose. Although the director is taking part in an initiative organized by an international body, this kind of activity is considered to be like communicating with a public official because government policy-makers are also invited (whether or not they actually attend). Therefore, as long as the director's contribution is based on a well-reasoned position, the resources of the charity devoted to developing such a charter are viewed as resources devoted to a charitable activity.

14.1.8 Scenario 8 — Joining a government advisory panel to discuss policy changes

A provincial government launches a Health Sector Initiative to look at ways of improving its service delivery to residents of the province. Healthy Retirement is asked to join an advisory

panel with other health charities and public officials to discuss possible policy changes. Based on a well-reasoned position, Healthy Retirement suggests that the province should increase its number of long-term hospital care beds for the elderly. Although the charity is recommending a change in provincial health policy, the charity's involvement in the advisory panel is a communication to a group of public officials based on a position that is well-reasoned. Therefore, the resources devoted to the activity are resources devoted to a charitable activity.

14.2 Prohibited activities

The following scenarios outline prohibited political activities.

14.2.1 Scenario 1 — Supporting an election candidate in the charity's newsletter

Healthy Retirement sends a newsletter to all its members that contains an editorial from the managing director of the charity conveying his views on the main issues it is currently facing. Just before an election, the director uses the column to give his personal support to the re-election of a candidate who happens to endorse a policy that the charity also supports. The director uses his personal funds to pay for that edition of the newsletter. In this case, the charity is engaging in a prohibited partisan political activity because although the director paid for that edition of the newsletter, it is an official publication of the charity and is being used to promote a candidate for an election.

14.2.2 Scenario 2 — Distributing leaflets highlighting lack of government support for charity goals

Healthy Retirement decides to distribute leaflets to members of the public during a federal election campaign. The leaflets highlight its research findings that drivers do not respect the pedestrian right-of-way at marked crosswalks. It also states that a private members bill that proposed to increase the penalties imposed on drivers failing to give the right-of-way to pedestrians at marked crosswalks did not become law because government-side Members of Parliament voted against it. In this case, the distribution of the leaflets is a prohibited partisan political activity because it could mobilize public opinion against the current government for failing to enact the private members bill.

Whatever the issue, a charity is not permitted to directly or indirectly support or oppose any political party or candidate for public office, at any level of government. Had the charity merely published a leaflet that showed how **all** the Members of Parliament voted on the private members bill, we would not have viewed this to be a partisan political activity.

14.2.3 Scenario 3 — Preparing dinner for campaign organizers of a political party

During a provincial election campaign, Healthy Retirement invites, to one of its monthly "heart smart" dinners, all those involved in organizing the campaign for a political party that promotes policies targeted at increasing health spending on respite care for seniors. The campaign team is treated to a delicious three-course meal that is low in fat and salt, and they receive information about the charity's programs. This is a prohibited partisan political activity because the charity is providing direct support, by way of a free meal, to campaign organizers of a political party.

14.2.4 Scenario 4 — Inviting competing election candidates to speak at separate events

Healthy Retirement invites a candidate in a municipal election, who is in favor of increasing the money available to deliver hot meals to seniors in poor health, to talk about a

particular issue on the candidate's electoral platform that is consistent with the charity's goals at its well-attended annual fundraising dinner. At a later date, it invites the other candidate in the election to speak at its poorly attended annual general meeting. The charity does not endorse either candidate at either meeting and no political fundraising occurs. Nevertheless, as the charity is not giving an equal opportunity for candidates seeking the same office to speak, it is possible to infer that the charity is indirectly supporting a particular candidate for public office and is therefore engaged in a prohibited partisan political activity. To avoid this assumption, a charity must ensure that in such circumstances, they invite all the candidates in an election to speak at the same time. Furthermore, the charity must give the candidates an equal amount of time to speak on their general platform.

14.3 Permitted political activities

A charity that devotes **substantially all** of its resources to charitable activities may carry on political activities within the allowable limits.

14.3.1 Scenario 1 — Buying a newspaper advertisement to pressure the government

Healthy Retirement takes out a full-page "Save Our Seniors" advertisement in a national newspaper to promote the well-reasoned position it has taken in its recent research. The advertisement states that the federal government is devoting proportionately less resources to senior health care now than ever before, and urges it to reverse this trend.

This is political activity because it is an explicit communication to the public that federal government policy on an issue that relates to Healthy Retirement's purposes should be changed.

14.3.2 Scenario 2 — Organizing a march to Parliament Hill

Parliament is debating the possibility of increasing the level of the Old Age Security benefits as a result of increases in the cost of fuel. Healthy Retirement has just published its research that sets out the well-reasoned position that 10% of seniors are malnourished because, once they have paid for fuel, they have little money to spend on food.

The executive director of Healthy Retirement sends an email to the charity's staff asking them to organize a march to Parliament Hill to coincide with the debate. He indicates that the purpose of the march is to highlight the charity's recent findings and to put pressure on Members of Parliament to vote for increases in the level of the Old Age Security Pension. On the day of the march, Healthy Retirement gives participants placards that state, "Seniors cannot afford to eat" and the address of the web site of the charity where the report can be downloaded.

As the executive director's internal email explicitly indicates that the purpose of the march is to put pressure on the government to change its policy on this issue, it is a political activity.

14.3.3 Scenario 3 — Organizing a conference to support the charity's opinion

Healthy Retirement organizes conferences and workshops to gain support for its point of view that penalties for motorists failing to observe the right-of-way or pedestrians at marked crosswalks need to be increased as a deterrent. It also advocates its well-reasoned position that all marked crosswalks should be updated to include a stop sign or light.

A charity that organizes a conference or workshop that explicitly promotes its point of view on an existing or proposed law, policy, or decision of any level of government, in Canada

or a foreign country, that relates to the way it achieves its purposes is engaged in a political activity.

14.3.4 Scenario 4 — Hiring a communications specialist to arrange a media campaign

A driver that failed to observe the right-of-way at a marked crosswalk accidentally kills three seniors from the same seniors' residence. There is a public outcry about the accident and the safety of marked crosswalks.

The provincial government where the accident occurs reviews its policy on marked crosswalks and holds consultations with stakeholders to get their views on the issue. Healthy Retirement is asked to present its well-reasoned position on the matter. The presentation is a charitable activity because Healthy Retirement is informing elected representatives about its work on an issue that is connected and subordinate to the charity's purposes and based on a well-reasoned position.

However, following its representation, Healthy Retirement concludes that the elected representatives were not enthusiastic about its well-reasoned position that marked crosswalks should be banned. The charity therefore decides to hire a communications specialist to arrange a media campaign to highlight its view that marked crosswalks should be banned. Note that this is not the same as saying that crossing at a crosswalk is four times as dangerous as crossing at a traffic light. From this point onwards, we will view the activity to be a political activity because the media campaign will explicitly communicate to the public that the law should be changed so that crosswalks are banned.

14.3.5 Scenario 5 — Using a mail campaign to urge supporters to contact the government

Healthy Retirement organizes a mail campaign by giving its supporters and members of the public a summary of its well-reasoned position on the dangers of marked crosswalks. The charity also encourages them to write to their municipal councilor and ask them to update the municipal marked crosswalks to include a stop sign or a light.

Whatever level of government the charity is urging its supporters and members of the public to contact, on whatever issue, such a communication is a call to political action and therefore a political activity.

14.3.6 Scenario 6 — Organizing a rally on Parliament Hill

Parliament is debating the possibility of increasing the penalties for offences in the *Criminal Code*. Healthy Retirement decides to organize a rally on Parliament Hill to coincide with the debate. When Healthy Retirement advertises the rally it invites the public to join in sending a message to Ottawa that Canadians want drivers who fail to stop at marked crosswalks should be charged under the *Criminal Code* with the offence of dangerous operation of a motor vehicle. Explicitly communicating to the public that the law should be changed in this way is a political activity. It is also a political activity to organize a rally with the explicit purpose of pressuring any level of government in Canada, or a foreign country, to change the law.

Political Activities and NGOs in England and Wales

Lindsay Driscoll

Consultant with Bates Wells & Braithwaite LLP

Former Legal Commissioner at the Charity Commission

1. Overview

In England and Wales there is a fundamental difference between the legal treatment of non-charitable, not-for-profit organizations and charities (public benefit organizations). The legal treatment, both for tax and regulation, is the same for membership and non-membership bodies.

Non-charitable, not-for-profit organizations are not subject to any regulation with respect to their status. They may be established and operate without any requirement for registration, and many do. If they wish to have the benefits of incorporation, they may register as companies limited by guarantee and they are then subject to the same light-touch regulation as commercial companies of an equivalent size.

Charities are generally subject to compulsory registration if they are above the income threshold of £5000 pa but there is no sanction for failure to register. All charities are entitled to very generous tax advantages.

2. Political Activities of Non-Charitable, Not-for-Profit Organizations

Non-charitable, not-for-profit organizations are not subject to any additional restrictions on their political activities beyond those imposed on individuals or other organizations. The main restrictions which apply to everyone are those imposed under Electoral law, mainly with regard to the maximum expenses allowable for a candidate, those imposed by the Communications Act 2003 which restricts political broadcasting, and some criminal offences under the Public Order Act, including trespassing and harassment offences, which apply equally to everyone.

3. Political Purposes and Activities of Charities

3.1 Definition

Under charity law, a political purpose is defined as, “any purpose directed at furthering the interests of any political party; or securing or opposing any change in the law or in the policy or decisions of central government, local authorities or other public bodies, whether in this country or abroad.”³⁴

Political activities have a similar meaning. The law on political activities is based in case law and there is no statutory law applicable. The rules relating to political activities are essentially part of the rules on public benefit. Every charity must exist for the public benefit, and since the courts have held that they are unable constitutionally to determine whether a change in the law or Government policy would or would not be for the public benefit, an organization with a political purpose cannot be a charity.

³⁴ The definition of charitable purpose is the one used by the Charity Commission and is a précis of Mr Justice Slade's dicta in *McGovern v. Attorney General* [1982] Ch 321.

The Charity Commission for England and Wales, the regulator of charities, publishes guidance on political activities.³⁵ The Charity Commission is a quasi-judicial body and is independent from Government in the exercise of its functions.³⁶

3.2 Charities cannot have a political purpose

A charity cannot be set up to pursue **purposes** which are party-political or aimed at a change in the law or Government policy (e.g., a charity could not be set up to campaign for a change in the law). However, as noted above, an organization which wanted to do this could always be set up as a non-charitable, not-for-profit organization and be free from the restrictions. It is also common to have a charity to carry out the charitable activities (and obtain the tax advantages) linked to a not-for-profit that carries out the political activities (e.g., Amnesty, Green Peace, Campaign against Arms Trade, etc.).

3.3 Political Activities

A charity can engage in some **political activities** to support charitable purposes (e.g., a charity set up to relieve poverty could campaign for a change in the welfare benefit laws). There are no absolute restrictions on the types of activities a charity can undertake: an individual could testify on behalf of a charity at a public hearing on a law or policy; an organization could advocate for changing a law or regulation; it could organize a petition or letter writing campaign of its members or supporters to Members of Parliament, Ministers, or Government officials asking them to join a protest; or, it could organize a demonstration. In this last case the general law on public order would apply.

There is also no absolute limit on the level of resources that can be spent on political activities. The test is that the political activities must not become the reason for the charity's existence. The latest version of "CC9 - Speaking Out – Guidance on Campaigning and Political Activity by Charities" states that it would be possible for the Board members to decide to spend all the resources of the charity on political activities for a limited period if they thought that this would be the most effective way of carrying out the purposes.

There are no restrictions on the foreign funding of charities or other not-for-profit organizations, so that the source of funding does not affect the legality of political activities in any way.

3.4 Party Political Activities

There are special rules with regard to party-political activities. A charity cannot provide financial support or support in kind to a political party. It could not send its staff or volunteers to distribute leaflets for or against a candidate. It cannot organize a campaign against or in support of any candidate to a public office or a political party before an election. It can, however, engage with a political party in ways that support its charitable purposes and can advocate support for particular policies of a political party (e.g., an environmental charity could support the green policies of a particular political party). It could also invite politicians to address its conferences, although it should maintain balance and neutrality and should not always invite speakers from the same party. It could hire out its premises to a political party for the full charge. In the context

³⁵ CC9 - Speaking Out - Guidance on Campaigning and Political Activity by Charities
www.charitycommission.gov.uk/publications/cc9.asp

³⁶ <http://www.charity-commission.gov.uk/>

of an election, restrictions are imposed by electoral law that apply to charities in the same way as to any other body.

3.5 Awareness Raising Activities

Awareness-raising activities and efforts to educate the public by mobilizing their support on a particular issue or changing public attitudes are not generally treated as political activities and therefore there would not be any restriction on them. However, there are fine lines between mobilizing support and campaigning for change in a government policy. Conducting a workshop or conference on an issue of importance where both views are expressed would clearly not be a political activity. Taking a position at a workshop would also not, by itself, be a political activity, although further action may fall within this category. Criticism of government policy or officials, either in a domestic forum or at an international forum, would also generally not be treated as a political activity. Monitoring election results, if undertaken in furtherance of a charitable purpose, is likely to be permissible, but the issue has not been raised and clearly decided upon. [To be clear, non-charitable, not-for-profit organizations are free to engage in election monitoring and all of these awareness-raising activities.]

3.6 Consequences of engagement in political activities

As these rules are a matter of charity law, the Charity Commission investigates any breaches of the matter. In most cases, they will simply give robust advice as to how to avoid a similar issue in future. However, in very extreme cases, they could take regulatory action, although this is very rare. The Charity Commission is a civil regulator, so no criminal offence would be committed and there is no concept of penalties.

3.7 Notification

There is no requirement for notification, and no specific requirement for reporting, although there would normally be some mention in the description of activities in the Annual Report.

4. Conclusion

To reiterate, the limitations relating to political purposes and activities described in section 3 apply only to charities. There would be no restrictions on any of these activities for non-charitable, not-for-profit organizations other than the restrictions imposed by the general law, particularly electoral law, on all individuals and organizations.

5. Further Reading

CC9 Charity Commission: This contains very full guidance on the charity law rules, the regulations under the general law and electoral law.

Advisory Group on Campaigning and the Voluntary Sector 2007: This includes recommendations for reform. The Charity Commission has amended their guidance to take account of this.

NGOs and Political Activities in France

Fabrice Suplisson
Consultant, ICNL

I. General Legal and Fiscal Framework

French law recognizes two primary legal forms of not-for-profit, non-governmental organizations (“NGOs”): associations and foundations. Associations may serve either a private or public benefit. An association is defined under the *Law of 1901 Relating to the Contract of Associations* (“Law on Associations”) as the “convention by which two or several people share, in a permanent way, their knowledge or their activity with a different aim than to share benefit. It is governed, as for its validity, by the general principles of the duty applicable to the contracts and obligations.” Public benefit associations fall into one of two categories: (1) general interest, and (2) public utility.

French law also recognizes three primary forms of foundations: (1) public utility foundations, (2) sheltered foundations, and (3) corporate foundations. Four other forms of foundations also exist but are not frequently created: research foundations, partnership foundations, university foundations, and scientific cooperation foundations. These foundations are all subject to different regulatory regimes; for example, only commercial entities may found a corporate foundation. All foundations must serve a public benefit purpose.

Trade unions, religious organizations, and political parties also qualify as NGOs. Under French law, there is no clear legal distinction between the notions of association (main form of membership organization) and of political parties. Under Article 4 of the French Constitution, “Political parties and groups shall contribute to the exercise of suffrage. They shall be formed and carry on their activities freely. They shall respect the principles of national sovereignty and democracy.” Article 7 of the Law No 88-227 of March 11, 1988 states that political parties have legal capacity; they may choose to be incorporated as an association under the Law on Associations of 1901, and thus be regulated under the provisions of that law.

The main distinction between an association and a political party is rather a practical, operational one: the participation of the latter in political campaigning, at national and local levels. Thus, on the one hand, an association that is not involved in political campaigns (see below under section 4. *Partisan Political Activities*) is not a political party. On the other hand, there are no explicit provisions under French law prohibiting the involvement of an association in political activities and political advocacy.

Simply registered associations and public benefit associations may thus engage in political activities.³⁷ A special category of associations may provide direct financial support to a political party or an election campaign. Such political associations are established for a limited period of time and are restricted to engaging in these stipulated activities only.³⁸ Public utility associations and public utility foundations may not engage *primarily* in political activities (Opinion of the *Conseil d’Etat* of June 13, 1978, No. 322894). In short, the extent to which

³⁷ An association may not engage in lobbying efforts for policies that would directly or indirectly benefit a director of that association; to do so would violate the financial disinterestedness requirement of the organization’s management.

³⁸ Political associations may receive contributions only from individuals and from the State.

NGOs can engage in political activities depends on the nature of their legal and public benefit status.

Public Benefit Status

French law recognizes two forms of public benefit status: (1) general interest, in which the organization's donors are eligible for tax benefits, and (2) public utility, which entitles the organization to the benefits of general interest status as well as additional tax and fiscal preferences. Organizations with public utility status are subject to requirements, such as stricter controls over the use of the organization's funds and over the distribution of assets upon dissolution.

Public utility status is granted by a decision of the Conseil d'Etat (highest administrative court), on a voluntary basis, to a very limited number of associations and is required for foundations (except corporate foundations and sheltered foundations). The status is granted under several conditions, one of them being the pursuit of a general interest purpose. A primary benefit of public utility status is to encourage donations (in vivo and post mortem) to the organization.

As mentioned above, public utility associations and public utility foundations may not engage *primarily* in political activities. A public utility association or foundation that engages primarily in political activities could face the withdrawal of its public utility status. The express restrictions imposed under French administrative law relating to the engagement of public utility organizations in political activities do not have a direct equivalent under tax law.

General interest status is regulated by French tax law. Indeed, the tax law refers to the notion of general interest (key for the deductibility of contributions to the nonprofit sector under Article 200 and 238b of the Tax Code) and social utility (key for exemption from VAT and corporate tax, for example). An organization is deemed to be of general interest based on a three-prong assessment relating to the disinterestedness of its governing body (directors and officers), its exemption from commercial taxes, and the fact that the organization is not run for the profit of a limited group of persons.³⁹

Campaigning, lobbying, and advocacy are not expressly regulated with regard to general interest status. Hence, the involvement of a general interest association in political activities is not *per se* precluded. It can be inferred from the last of the three prongs that the general interest of an organization involved in political advocacy and lobbying on behalf of a limited group of persons (for example, a targeted category of professionals gathered in a professional association) could rightfully be denied. On the other hand, political advocacy and lobbying to promote issues concerning a wider range of the population would not necessarily undermine the notion of general interest (for example, the promotion of changes in the legislation to promote broader access to social benefits, to culture and education or sport, etc.).

³⁹ *Instruction. du 26 février 1988, BOI 4 C-2-88, et du 8 mars 1988, BOI 5 B-13-88 (Fr.)*. According to the tax regulation DB [*Documentation fiscale de Base*] 5B 3311 § 14 are deemed run for the benefit of a limited group of persons organizations which purpose would be to serve the interests of one or several families, persons or companies, to promote the work of a few artists or researchers.

II. Permissibility of Activities

1. Legislative-Regulatory Reform

Under French law, there are no legal barriers or restrictions for a NGO to conduct the following specific activities:

- Testifying on behalf of an NGO in a public hearing on a law or policy.
- Advocating for changing a law or a regulation/decision, for example, through drafting an analysis/recommendations and submitting them to the relevant government/parliament body without receiving an official invitation to submit such analysis/recommendations.
- Sending letters/emails to its members and non-members, asking them to join a protest meeting in front of the Parliament/Government building or asking for their signatures on a letter to be sent to the Parliament/Government on an issue of concern.

2. Awareness-Raising Activity

There are no restrictions under French law for an NGO to organize and participate in any awareness-raising activities. A NGO under French law may therefore:

- Conduct a workshop or conference to educate the public on an issue of importance and take a position on the issue; and
- Criticize government policy or officials either in a domestic or international forum.

3. Non-Partisan Election Monitoring

There are no restrictions under French law relating to NGO involvement in election monitoring. A NGO is permitted to undertake exit polls of voters after elections.

4. Partisan Political Activities

General Restrictions on Funding of Political Parties and on Contributions to Election Funds

France has significantly revised its legal framework applicable to political parties and political campaign activities since 1988 when legislation was adopted, conferring express legal personality to political parties. Notably, legislation was enacted in 1995, which prohibited legal persons, including companies and nonprofit organizations (but excluding political parties), to provide private funding to political parties and political campaign activities.⁴⁰ Government funding of political parties in France amounts to more than €70 million each year.

a) Political parties

Political parties are granted legal status under the French Constitution. Their resources come mostly from public funding, which is allocated each year, based on the party's results in the first round of the last legislative election (and if the party presented candidates in at least 50 electoral districts and raised at least 1% of the votes). A lump sum is allocated to new political parties as long as they have collected private funding from at least 10,000 natural persons. Political parties may receive private funding from natural persons (which gives rise to a tax

⁴⁰ The law of 1995 was mostly an anti-corruption law in reaction to several public scandals involving the secret funding of mainstream political parties by private companies.

deduction for the donor), but are prohibited to receive such funding from legal entities, regardless of legal form or status (companies, nonprofit organizations, etc.).

b) Contributions to election funds

Private funding of political campaign activities may come only from natural persons and political parties. There is no limit to the amount of private funding from political parties. Funding from natural persons may not exceed €4,600. Within the last three months preceding an election, the use of advertising for purpose of political propaganda through the press or any audiovisual communication is prohibited.⁴¹ In electoral districts exceeding 9,000 people, a cap is placed on political campaign expenditures according to the number of inhabitants. In addition, the candidates must name a financial trustee, which may be either a natural person, or a campaign funding association incorporated as an association under the Law on Associations of 1901. The trustee is the only person authorized to receive funding and pay expenses. The trustee must produce a financial statement for the campaign and have it approved by a certified public accountant. The statement is submitted to the control of an independent commission (CCFP). Any violation is a criminal offense and may lead to the impeachment and future ineligibility of the candidate. A candidate, who gets at least 5% of the votes in the first round of the election may be reimbursed for up to 50% of political campaign expenditures allowed for the given political district (a candidate, who limits his/her expenditures to 50% of the limit defined by law could therefore end up with a 100% government funded political campaign).

c) NGOs and contributions to political parties and election funds

The involvement of NGOs in the funding of political parties and election funds is prohibited, except for associations created specifically for political campaign funding purposes.

Restrictions on Foreign Funding of Political Parties and Campaigns

French law⁴² has established a broad prohibition against any foreign financial contribution or material support to political parties and political campaign activities. An electoral funding association or financial trustee of a political party is prohibited from receiving any direct or indirect financial or in-kind contribution from a foreign state or foreign legal person. It should be noted that the prohibition applies to financial contributions from foreign political parties; only French political parties may contribute financially to political activities and campaigns.⁴³

There is no definition under French law of what constitutes a foreign financial contribution, or material support under the above-mentioned provision and the only case law on this issue relates to a political party whose funding was mostly coming from a foreign political party.⁴⁴ It is therefore not clear, considering the breadth of the definition, whether a French political party would be prohibited from receiving a grant from an international organization, for a purpose that is not linked to an election or political campaign. In addition, it is not clear

⁴¹ Article L. 52.1-1 of the Electoral Code. The existence of a candidate's website is not deemed advertising, "Communication électronique et réglementation des campagnes électorales" Club Moderniser la vie locale, p.14, see http://bohbot.typepad.com/mon_weblog/files/CMVL251006.pdf (fr.) as of August 19, 2009

⁴² Article 11-4 of law n° 88-227 of 11 March 1988 on transparency of political life and Article L.52-8 of the Electoral Code.

⁴³ Conseil d'Etat (highest administrative court), n° 212044, 8 December 2000, *Parti National Basque ERI-PNB*.

⁴⁴ *Ibid.*

whether the term “financial contribution” would apply to a quid pro quo relationship such as the implementation of a training session purchased by a French political party for its staff members or volunteers from a foreign legal person (corporation, international organization).

As mentioned previously, French Law prohibits legal persons, including NGOs, from funding political parties or contributing to election funds. Consequently, a French NGO, whatever the source of its funding - domestic or foreign - may not provide financial contributions to political parties or election funds.

Political Activities of NPOs in Germany

Dr. Michael Ernst-Pörksen
euroCom - Gesellschaft für europäische Kommunikation e.V.
Berlin, Germany

1. Overview

Germany is a federal, civil-law country with three primary forms for not-for-profit, non-governmental organizations (NPOs):

- associations (*Verein*);
- foundations (*Stiftung*); and
- limited liability companies (*Gesellschaft mit beschränkter Haftung, GmbH*).

Exemptions from broad categories of taxation are available to those NPOs, regardless of legal form, that exclusively and directly pursue public benefit, charitable, and church-related purposes.

NPOs in Germany are generally permitted to engage in political activities. Restrictions relating to political activity apply predominantly to tax-exempted NPOs.

Increasingly, since the early 1980s, the German government and public administration have sought and supported cooperation with NPOs. The government sees a strong NPO sector as a prerequisite for further democratic development and for social cohesion in society. Growing parts of the public budgets are reserved for strengthening the NPO sector and encouraging people to engage in public and social issues, and the government sees NPOs as having a crucial role in the process of political decision-making. Consequently, public hearings in advance of parliamentary decisions on legislation have become routine, as has NPO participation in parliamentary hearings.

1.1. Legal Forms of NPO

An association is a membership organization whose members have come together to permanently pursue a common purpose. Associations can exist without being registered and without legal personality (see *Bürgerliches Gesetzbuch* or “Civil Code”), Article 54). Non-economic associations (*nichtwirtschaftliche Vereine / Idealvereine*), whose main aim and activity must not involve the conduct of business, receive legal personality upon registration at the local court. Both public-benefit and mutual-benefit associations are permitted.

A foundation established under Articles 80-88 of Civil Code (*Stiftungen bürgerlichen Rechts*) is a legal entity whose earnings on assets are used to pursue a specific purpose laid down

by the founder. The current Federal legislation in the Civil Code, which was modified in 2002 (Law to Modernize the Foundation Law, July 15, 2002 - *Gesetz zur Modernisierung des Stiftungsrechts*), is not extensive. Foundations are more extensively regulated by the laws of the 16 states (*Länder*). German law permits both public-benefit and private-purpose foundations. In addition, foundations may choose to operate as non-incorporated foundations, established on a trust basis; non-incorporated foundations are assuming growing importance, as they may enjoy the same tax privileges as foundations established under the Civil Code regulations.

NPOs may also take a corporate form, specifically the limited-liability company *Gesellschaft mit beschränkter Haftung* or GmbH (registered and regulated under a special law). The GmbH is a commercial company in corporate form with legal personality. It has stock, which originates from its shareholders. The shareholders are not liable for the debts of the company. NPOs often choose this legal form when their purpose includes the delivery of services without remuneration.

1.2. The General Tax Code (“Abgabenordnung”)

German tax law generally exempts from corporate tax (*Körperschaftsteuer*), commercial tax (*Gewerbesteuer*), and gift and inheritance tax (*Erbschaft-und Schenkungsteuer*) only those NPOs that exclusively and directly pursue public-benefit, charitable, and church-related purposes. The exemption is available to all corporations, regardless of legal form. In order to get and keep tax benefits, the NPO must report annually to the tax authorities on their activities and submit financial reports. Tax privileges require that the NPO does not - either through its statutes or through its actual activity – act against the free democratic basic order of the Federal Republic of Germany.

2. Political Activities

The regulatory approach toward NPO engagement in political activities is dependent on the tax status of the NPO. On the one hand, organizations without tax-privileged status are generally permitted to engage in a wide range of political activities, including support for political parties. On the other hand, organizations pursuing tax-privileged purposes must not spend any of their assets for the direct or indirect benefit of political parties (AO Article 55 section 1). [General political education and the general support of democratic development both qualify as tax-privileged purposes.]

The administrative regulations governing the application of the German Tax Code (*Anwendungserlass, AEAO* or (“AO”)) in the commentary to Article 52 AO state that political purposes do not qualify as public-benefit purposes. In the discussion of what “political” means, the regulation says that some activities relating to the development of public opinion are acceptable. An organization is allowed to comment on politics related to its public-benefit purpose. In this respect it is also allowed to communicate with legislators about proposed legislation without losing tax-exempt status.

There are, besides the general annual reporting requirements, no specific reporting or notification requirements relating to political activities.

2.1. Legislative-Regulatory Reform

All NPOs, regardless of tax status, are permitted to advocate for further legislative development in their respective fields of knowledge and experience. The German government considers such engagement as assistance in its efforts to improve the living conditions of the

German public and the natural environment, and also in the interest of Germany's reputation abroad. Members of federal, regional, and municipal parliaments often seek closer communication with NPOs, in order to benefit from deeper insights into social and cultural issues and in order to reach out to those who live under less fortunate conditions, and are less able to address public administrations or political representatives.

As mentioned above, even tax-exempted NPOs are allowed to comment on political issues related to their public-benefit purpose. They are also allowed to communicate with legislators in reference to proposed legislation. NPOs may participate in public hearings, which are routinely held in advance of parliamentary review of proposed legislation. Representatives of NPOs regularly take part in parliamentary hearings, based on their specific expertise. Further, tax-exempted NPOs may conduct political campaigns, but only in the framework of their statutory purposes.

2.2. Awareness Raising Activities

All NPOs, regardless of tax status, are permitted and encouraged to organize and participate in awareness-raising activities. Indeed, public administrations welcome NPO activities in this area, as experience has shown that a higher level of communication is likely to lead to better results relating to inevitable and deliberate changes in public policies.

There are no restrictions for NPOs in monitoring elections. Tax-exempted NPOs analyze party programs with regard to policy fields relevant for the purposes they pursue; the NPOs may make the results of their analysis publicly available and in this way try to influence voting decisions. NPOs may also conduct preliminary or exit polls.

2.3. Partisan Political Activities

With regard to partisan-political activities, NPOs (without tax exemptions) may take part in campaigns and may make monetary contributions to political parties. It is, however, incumbent on the political party to make these contributions public. In contrast, tax-exempted NPOs may not act as direct supporters of political parties; they are not allowed to support or campaign for political parties or their political representatives. If they do so, they will face the likelihood of losing their tax benefits.

2.4. Foreign funding of NPOs

Foreign funding of NPOs is not subject to specific regulatory treatment in Germany. Of course, NPOs must comply with regulations against money laundering and the financing of terrorist activities. In the framework of these regulations, "know your customer" principles have to be followed, and financial transactions from countries outside the European Union are subject to notification requirements. But these regulations do not specifically target foreign funding of NPOs and their activities, but instead apply to all natural and legal persons living or having their legal seat in Germany. Aside from these restrictions, the German regulatory framework does not hinder any kind of cross-border giving.

NGOs and Political Activities in Hungary

Nilda Bullain
Executive Director
European Center for Not-for-Profit Law
Budapest, Hungary

Summary Overview

In Hungary, the three main forms of NGOs – associations, foundations and nonprofit corporations – are generally free to engage in all forms of political activities. In fact, NGOs in Hungary are not only allowed, but also encouraged by the legal-institutional framework to take part in the decision-making process of Government and Parliament through a wide range of advocacy, campaigning, and lobbying activities.

Some restrictions apply, however, if the organization is also registered as a public benefit organization (PBO). In this case, the NGO must not pursue direct political activity, but instead must be independent of political parties, and it must not provide financial support to them [Act CLVI/1997, Article 4(d)]. The definition of “direct political activity” is narrow; in fact, even PBOs may nominate and/or support candidates for *local* elections.

There is no clear legal guidance, however, as to when a PBO, which is legitimately involved in campaigning and advocacy, violates the independence requirement. Although there have been scandals involving NGOs that used public funds for illegitimate political party support, there has been no case law yet to help determine “good practice” or the limits of political involvement of PBOs in Hungary.

Basic Legal Framework

There are three main forms of organizations that can be considered NGOs: associations, foundations, and nonprofit corporations.

Associations are one form of the “social organization” established under Act II/1989 (Law on Association), which is the main form of membership-based organizations and includes political parties, trade unions, and professional bodies as well. According to Article 1 (3) of this Act, “a social organization may be created for any purpose that is consistent with the Constitution and is not unlawful.” A social organization may not be created for a primarily economic/entrepreneurial purpose, and it cannot be an armed organization (Article 1 (3)). There are no further prohibitions regarding its purposes, i.e. an association may be established for a primarily political purpose [e.g. as Friends of the Socialist Party]. The law does not list the possible forms of social organizations but it refers to other laws that govern some of the forms they may take, including Act IV/1959 (Civil Code), which governs associations and Act XXXIII/1989, which governs the operation of political parties.

The establishment and operation of foundations is regulated in the Civil Code, while the establishment and operation of nonprofit corporations is regulated in the Company Code (Act IV/2006).⁴⁵

⁴⁵ It should be noted that while all three of the mentioned legal forms satisfy the general criteria for nongovernmental, not-for-profit organizations as defined in relevant literature internationally, Hungarian legislation tends to regard only foundations and associations as “civil organizations”, which is the term closest to defining “NGO” under Hungarian law. “Civil organization” was first defined in the Law on the National Civil Fund (Act

None of these three main Acts governing nonprofit organizations in Hungary place any restrictions on legislative or political activities of NGOs. Foundations, associations, and nonprofit corporations may nominate and support candidates and legislation freely.

Some restrictions apply, however, if the organization is also registered as a PBO, as described in the following section.

Public Benefit Organizations

Article 2 (1) of the Law on Public Benefit Organizations (Act CLVI/1997) lists the following legal forms registered in Hungary as eligible to receive a public benefit status (PBO status):

- social organization, except insurance associations, political parties and employer and employee representations;
- foundation;
- public benefit foundation;
- public body association, if the law establishing it allows for this possibility;
- national sports federation; and
- nonprofit corporation.

As can be seen, all three forms of NGOs may be eligible to receive the PBO status, provided they fulfill certain criteria spelled out in the Law on PBOs. The criteria include restrictions to the political involvement of the NGO, namely: its founding documents must state that it does not pursue direct political activity, it is independent of political parties, and it does not provide financial support to them [Act CLVI/1997, Art. 4(d)].

Under Article 26 (d) of the same Act, "direct political activity" includes "political party activity and nomination of candidates for Parliamentary and local governmental elections at the county level, including the city of Budapest." The prohibition does not apply to the nomination of candidates for local elections at the municipal level (including districts of the capital). Furthermore, although PBOs cannot support political parties, political parties may support PBOs.

The main incentive for NGOs to apply for the public benefit status is the possibility to provide a certificate to their donors, which makes the donor eligible for a tax benefit regarding its donation to the PBO. There are also other benefits, e.g. a higher threshold of tax exemption for economic activities than for other NGOs, or the possibility to provide tax-exempt reimbursements to volunteers. About half of the registered NGOs (including all three legal forms) in Hungary also have the PBO status.

L/2003) and included foundations and "social organizations established under Act II/1989 except political parties, foundations of political parties, associations created with the participation of a political party, interest representation organizations of employees, employers, and economic interests, insurance associations and public foundations." (Art 14.b of Act L/2003) This definition excludes nonprofit corporations, which are not even mentioned. Since then the government and several ministries used this term in their regulations pertaining to cooperation with and support of NGOs.

Legislative – Regulatory Reform

NGOs in Hungary are not only allowed, but also encouraged by the legal-institutional framework to take part in the decision-making process of Government and Parliament.

Advocating with Government

According to Article 36 of the Constitution of Hungary (Act XX/1949), “the Government, in the course of fulfilling its tasks, cooperates with the social organizations.” This constitutional provision translates into concrete legal possibilities as well:

(a) The Act on Legislation (Act XI/1987), which describes the process of law making “contains numerous explicit provisions on the legislative process to be carried out with civil organizations. Under Article 20, civil organizations shall be involved in drafting those regulations which ‘pertain to the interests or affect the social conditions which they represent and protect’; under subsection (2) Article 22, their recommendations shall be invited in compiling the legislative program; under provision b) Article 27, civil organizations shall express their opinions on the drafts to be submitted to the government; and under Article 29, a similar procedure shall be followed in the case of drafts of ministerial decrees and ordinances of state secretaries.”⁴⁶

(b) The Law on the Freedom of Electronic Information (Act 90/2005) requires every government body (including the central and local levels) to publish legal drafts and concepts on their websites (with limited exceptions relating to classified information), and to ensure that comments can be made by anyone during a period for public consultation (i.e. the website should be able to receive comments).

In addition, several ministries have introduced specific procedures for working with NGOs and have established consultative (advisory) bodies in their respective fields. Thus, NGOs, including PBOs, are permitted to advocate for changing a law, for example, by submitting their analysis and recommendations, even without receiving an official invitation to submit their proposals. In fact, based on Act 90/2005, any citizen may do that now. However, in many fields (culture, environment, labor, social affairs, etc.) there are institutional mechanisms established for NGOs through which they can become well informed, may submit their views on a regular basis, and monitor the government’s work in the given field.

Furthermore, though not commonly practiced, it also happens that an NGO representative can appear at a governmental or inter-ministerial meeting, such as when the President of the Hungarian Association of Development NGOs testified at the governmental meeting which discussed the need for a Law on Official Development Assistance, as part of the submissions made by the Ministry of Foreign Affairs.

Advocating with Parliament

Although the abovementioned Constitutional and legislative paragraphs pertain to NGO participation in Government’s work, these principles are widely understood to apply to the work with Parliament as well.

⁴⁶ Quoted from the publication *Civil organizations in the legislative process*, Edited by Judit Fridli and Ildi Pasko, a Publication of the Hungarian Civil Liberties Union, Budapest, April 2000; translation: ECNL

The Hungarian Parliament has a so-called Civil Office, which maintains a database of NGOs that have registered (on a voluntary basis) to be notified about the work of certain committees. They receive an email about the work-plan and schedule of committee meetings and can indicate if they would be interested in attending a meeting, either to observe or to speak to a certain agenda point. In this case, they also receive all documentation related to the meeting (except if there are confidential materials), and are allowed to express their views.

Notwithstanding the above, NGOs, including PBOs, may submit position papers, opinions, policy papers, analyses, and recommendations to members of the Parliament at any time, and they do so on a regular basis. NGOs, including PBOs, may also organize campaigns and protests for or against a legislative initiative, including freely mobilizing their members to write letters, send emails, join a protest event, or any other campaign activity relating to a certain piece of legislation. However, the restriction against PBOs from engaging in activity related to the election of a political party or its candidate applies.

Awareness Raising

NGOs in Hungary are free to conduct a workshop or conference to educate the public on an issue of importance with or without taking a position on the issue. For example, during the government's campaign for EU accession, there were NGOs who campaigned in support of the accession; there were others who held workshops, conferences, and public events about why people should vote against accession; and there were NGOs which aimed to present a fair assessment of the arguments of both sides and organized educational events to discuss advantages and disadvantages of joining the EU.

NGOs can also criticize government policy or officials at any time and at any place, based on the freedom of speech enshrined in the Constitution and in domestic and international law. A recent example: Transparency International Hungary issued a statement in the form of an open letter to the Prime Minister in which it criticized the appointment of the Minister of Economy in the newly formed government, because in the past, his company had been found liable by the Company Court for participating in a cartel. TI Hungary publicly opined that a Minister with such past history could not be expected to battle effectively against corruption. As a consequence the Minister stepped down (or was asked to do so) and a new Minister was appointed. Everyone, including government, opposition, and the media accepted that TI Hungary, as an NGO, had called public attention to relevant information on which they based a professional statement, and thus it was seen as a legitimate criticism aimed at strengthening democracy in the country.

Non-partisan Election Monitoring

NGOs, including PBOs, are allowed to participate in election monitoring and exit polls. However, they must observe the general prohibition of campaign silence laid out in the Law on Elections and Electoral Procedures (Act C/1997), which does not allow any public campaigning activity starting 24 hours before the start of elections and lasting until the close of the polls on Election Day (thus, NGOs are not allowed to communicate the results of the exit polls until the voting is over).

Partisan Political Activities

NGOs in general can make monetary contributions to political parties, provide facilities, endorse party candidates, and conduct similar partisan activities. However, if an NGO holds or

aims to hold a public benefit status, they cannot be involved in “direct political activities.” This means, according to the Law on PBOs, “political party activities, and nominating a candidate for national, county, and capital city elections.” There are two issues to be noted here:

- It is not clear what the law means by “political party activities;” however, it is usually interpreted as those activities which are reserved for political parties according to various laws, especially the Law on Elections, such as holding electoral meetings, promoting the party program, collecting funds for the party, and nominating candidates (which is also spelled out separately).
- This definition of direct political activities also means that even PBOs can nominate a candidate for local elections or district elections within the capital, which they do. NGO candidates often represent the determining vote in a city government, where the votes of their one or two representatives may be decisive among the competing factions.

And, for the first time in 2006, a candidate nominated by a (non-PBO) NGO also was voted into the Parliament (and later became a Minister for Local Self-Government).

Except for “direct political activities,” all the above-described forms of “political” engagement are allowed for PBOs in Hungary. At the same time, they must be “independent from political parties” in order to receive the status. Theoretically, if they lose their independence, the PBO status may be revoked by the court. However, there is no clear legal guidance as to when a PBO, which is legitimately involved in campaigning and advocacy, violates the independence requirement. Although there have been scandals involving NGOs that used public funds for illegitimate political party support⁴⁷, there has been no case law yet to help determine “good practice” or the limits of political involvement of PBOs in Hungary.

Foreign funding

According to the Law on Operation and Financing of Political Parties (Act XXXIII/1989), political parties may not accept monetary support from a foreign government (Article 4 (3)). However, such restriction does not apply to NGOs in any form; therefore there are no restrictions for NGOs supporting political parties to accept support from a foreign government and then support the political party as a domestic NGO. (However, PBOs may not support political parties.) At the same time, parties have to report on all donations (including monetary and in-kind support) they receive, listing the name of the donor and the amount. Anonymous donations cannot be accepted; those would have to be paid to the Foundation of the Party (Article 4(3)).⁴⁸

⁴⁷ According to the Law on the Operation and Financing of Political Parties, parties may only receive a certain amount of public funding (calculated based on a quota related to their election results). In the past years, parties tried to circumvent this restriction by “assisting” to channel public funds to NGOs which in turn provided them with monetary support (in a non-transparent manner).

⁴⁸ Hungary (following the German model) also has a law on “scientific, awareness raising, research and educational foundations supporting operations of political parties”, Act 47/2003. They are subject to more rigorous financing rules than general foundations.

NGOs and Political Activities in the United States⁴⁹

1. Overall Legal Framework

1.1. Legal Organizational Forms

The formation and establishment of not-for-profit organizations in the United States is determined and governed by state law (as opposed to federal law). There are 3 basic types of not-for-profit organization:

1. *Nonprofit Corporations*: The most common legal vehicle for not-for-profit activities in the United States is the nonprofit corporation. Generally, nonprofit corporations, like their for-profit/business counterparts, provide legal-entity status, limited liability, and perpetual duration. They are governed by a board of directors, which usually has broad discretion to decide how best to pursue their objectives. The chief difference from for-profit corporations is that nonprofit corporations – certainly the type that are created for public benefit – must dedicate their assets to their charitable, nonprofit purposes and not distribute assets or profits to members, shareholders, or other insiders (other than paying employees reasonable compensation for services rendered).
2. *Trusts*: The chief alternative to the nonprofit corporation is the trust. While corporations are created pursuant to statute, the law of trusts is largely a creation of the common law (though many states have, to varying extents, passed statutes codifying trust law). Fundamentally, a trust is a device by which one or more legal persons hold legal title to property, but do so for the benefit of some other person, class, or purpose. Thus, the conceptual focus of trust law is not on the trust as a separate legal entity, but rather on the duty of the trustees to use the property as the settlor (creator) of the trust wished, and not for their own private purposes. Trusts can be either private or charitable. It is uncommon nowadays for charities to be formed as trusts; occasionally family-controlled philanthropies that are private foundations under Federal tax law are formed as trusts rather than nonprofit corporations.
3. *Unincorporated Associations*: Groups of individuals can form unincorporated associations governed only by their mutual agreement, and requiring no registration with the state. These membership associations are extremely flexible but possess the drawback of having no legal structure and of exposing all members to potential liability for actions and debts of the association.

1.2. Tax Law Categories

Within the overarching category of tax-exempt organizations (organizations that are formed as nonprofits under state law and include various required provisions in their organizing instruments, such as a charter or certificate of incorporation) US tax law contains several categories. For purposes of this memorandum, the most important categories are “public charities” and “private foundations” (referred to collectively here as “charitable organizations”), and “social welfare” organizations.

⁴⁹ This section was authored by ICNL staff, with the substantial input of W. Cole Durham, Jr., Brett G. Scharffs, Michael W. Durham, and Rochelle Korman. ICNL would like to express its appreciation to all of them. Sections 1.1, 1.2 and 2 are derived from *The United States Law of Charities: A Summary*, by W. Cole Durham, Jr., Brett G. Scharffs, and Michael W. Durham, March 2005, http://www.icnl.org/knowledge/pubs/ChinaConference/Law_Regulation_NPOs_US_Overview.pdf.

1. *Charitable Organizations:* These are often referred to as 501(c)(3) organizations, because this is the key Internal Revenue Code provision governing such entities. Charitable organizations must be both (1) organized, and (2) operated exclusively for one or more public benefit purposes.

The US tax law distinguishes between two principal classes of charitable organization: the public charity and the private foundation. The difference between these two, in rough terms, has to do with the nature of their funding and their susceptibility to being controlled by private interests because financial support rests in the hands of very few contributors. Certain types of organizations including schools, hospitals, churches, and medical research organizations are automatically public charities. Other organizations must meet one of two support tests designed to measure the extent to which the organization gets its support from a broad section of the public rather than from a few individual donors. Organizations with relatively broad support from a large number of individuals are generally public charities while organizations that depend principally on a few large donors or their own investments are private foundations. Charitable organizations not falling into one of these categories are determined to be private foundations, which are subject to special restrictions. Charitable organizations are prohibited from activities on behalf of or in opposition to a candidate running for elective office. Public charities, however, (not private foundations) may engage in a limited amount of activities supporting or opposing legislative efforts. Contributions to charitable organizations provide donors with advantageous tax benefits.

2. *Social Welfare Organizations:* Social welfare organizations (also called 501(c)(4) organizations) are very similar to charitable organizations. Like charitable organizations, social welfare organizations must keep their assets permanently devoted to their public benefit purposes, and cannot distribute net earnings to individuals or other private interests. Both are subject to the private inurement and private benefit tests. The main difference, and it is an important one, is that social welfare organizations may engage in unlimited amounts of lobbying activity, or activity that is geared to influence legislation in furtherance of their public policy goals. Thus, for example, a social welfare organization dedicated to stopping drunk driving could devote itself to contacting legislators and urging them to enact harsher penalties for that crime. Social welfare organizations also may engage in some political/electoral activity – activity on behalf of or in opposition to a candidate running for election to a public office. The trade-off for being able to undertake these unlimited legislative and limited political/electoral activities is that contributions to 501(c)(4) organizations do not give donors any of the tax benefits provided to donors to charitable organizations.

2. Political Activities and Legislative Lobbying Activities

As noted above, 501(c)(3) public charities (but not private foundations) may not devote any substantial part of their activities to influencing legislation; social welfare organizations — which are not eligible for those tax-deductible contributions, but are still exempt from income tax — may engage in unlimited lobbying activity, so long as it is related to their social welfare purpose.

The restriction on the amount of lobbying/legislative activities is limited to when the organization (1) contacts, or urges the public to contact, members of the legislature regarding a specific legislative proposal; or (2) advocates for the adoption or rejection of specific legislation. The law preserves the government's ability to benefit from nonprofits' experience by (1) allowing nonprofits to *respond* to legislative requests for their views; (2) allowing them to

provide nonpartisan analysis on general policy questions; and (3) allowing some amount of lobbying as issues come up, so long as they do not become a substantial part of the organization's activities.

Because the line between substantial and insubstantial activities is not a precise one, charitable organizations historically could not take advantage of their permission to conduct "insubstantial" lobbying activities without running the risk of losing their tax exemption. That changed in 1976, when Congress allowed charitable organizations to elect to apply a very specific expenditure test in lieu of the vague "insubstantial part" test. Electing organizations may spend a certain percentage of their overall purpose-related expenditures on lobbying; that percentage depends on the size of the organization, ranging from 20% for small organizations to slightly more than 5% (but no more than \$1,000,000) for large organizations. Appeals to the public to contact their legislator(s) (known as grassroots lobbying) are subject to a separate cap of one-fourth the size of the restriction on direct lobbying.

2.1. Legislative Regulatory Reform

While a 501(c)(4) social organization may engage in an unlimited amount of lobbying activity, a 501(c)(3) public charity may engage only in a limited amount of lobbying activity. As defined above, lobbying refers to (1) making contact with, or urging the public to contact, members of the legislature regarding a specific legislative proposal; or (2) advocating for the adoption or rejection of specific legislation. In other words, lobbying is a communication that refers to or reflects a position on a pending piece of *legislation*. Lobbying *does not include* communication referring to regulatory actions of the executive branch. For example, an appearance before a government agency arguing that the agency should issue a particular regulation is not lobbying. Appearing before a Congressional committee or meeting with a senator or representative about a bill either already introduced or about to be introduced is generally considered to be lobbying. At the same time, however, testimony provided at the formal written request of a committee holding hearings on a bill or for policy analysis is not considered lobbying. As noted above, private foundations may not lobby at all, but they may be involved in regulatory efforts because regulatory efforts are not considered to be lobbying.

Lobbying limits affect 501(c)(3) public charities in the following ways:

- A public charity may develop model legislation or analysis of an issue, but must be careful about participating in debates relating to legislation that has been or is about to be introduced, unless the organization is able to count that lobbying work within its permitted ceiling.
- Under certain circumstances, a public charity can send letters/emails to its members and non-members, asking them to join a protest meeting in front of the Parliament/Government building or asking for their signatures on a letter to be sent to the Parliament/Government on an issue of concern. The key issue is the nature of the protest. A general protest over an issue (such as the death penalty) that relates to no piece of pending legislation is not considered lobbying, and therefore is permissible. Activity that encourages citizens to urge their representatives to take a particular position on a piece of legislation is considered grassroots lobbying and is therefore subject to a greater dollar limitation than direct lobbying (for example, where the organization leadership directly speaks with legislators). Of course, activity directed toward influencing the Government is not lobbying and is therefore permissible.

2.2. Awareness Raising Activities

Not-for-profit organizations, regardless of tax status, are generally allowed to engage in a broad range of awareness-raising activities. They can:

- conduct a workshop or conference to educate the public on an issue of importance *without* taking a position on the issue, but rather presenting both sides of the issue.
- conduct a workshop or conference to educate the public on an issue of importance *and* take a position on the issue (for example, arguing that a country should accede to the WTO or that it's important to create an enabling environment for civil society). The only restriction for this activity relates to a 501(c)(3) organization taking a position on pending legislation; in this case, the organization's activities would be considered lobbying, and therefore would be subject to special lobbying limits.
- criticize government policy or officials either in a domestic forum or at an international forum (such as the UN Human Rights Council) by, for example, highlighting corruption or complaining about human rights violations.

A public charity is also permitted to engage in non-partisan election monitoring, but only under very tight restrictions.

2.3. Partisan Political Activities

As stated above, charitable organizations are completely prohibited from engaging in partisan political activities. For example, they cannot make a financial contribution to a political party; provide a conference room for a meeting of a candidate to a public office or a political party and the general public or its own members; send staff or volunteers to distribute leaflets for or against any candidate to a public office; or organize a campaign against or in support of any candidate for a public office or a political party before elections.

2.4. Penalties for Non-Compliance

In case of non-compliance with the restrictions described above, available sanctions include penalty taxes and the revocation of tax-exempt status.

2.5. Foreign Funding

US law imposes no limits or restrictions on the receipt of foreign funding by US not-for-profit organizations. For regulatory purposes, the issue of foreign funding is simply not relevant for purposes of the issues raised in this report.

2.6. Applications/Notifications or Reports

The annual tax return form 990 includes a section devoted to accounting for lobbying activities. Public charities that lobby are required to maintain contemporaneous records of lobbying activities by staff and must allocate time and related expenses, including overhead costs.

V. Conclusion

From the foregoing country reports, we can identify several principles or common regulatory practices:

(1) NGOs – at least some legal form of NGOs – are generally permitted to engage in the following activities:

- Testify on behalf of an NGO in a public hearing on a law or policy;
- Advocate for changing a law or a regulation/decision;
- Contact its members and non-members, asking them to join a protest meeting in front of the Parliament/Government building or asking for their signatures on a letter to be sent to the Parliament/Government on an issue of concern;
- Conduct a workshop or conference to educate the public on an issue of importance *without* taking a position on the issue, but rather presenting both sides of the issue;
- Conduct a workshop or conference to educate the public on an issue of importance *and* take a position on the issue;
- Criticize government policy or officials either in a domestic forum or at an international forum;
- Conduct exit polls of voters after elections.

(2) Indeed, in some countries, many NGOs – or at least certain categories of NGOs – are permitted to engage in partisan political activity. For example, these NGOs may:

- Make a monetary contribution to a political party;
- Provide their conference room to a candidate for public office or to a political party in order that he/she/it may meet with the general public or its own members;
- Task their staff and volunteers with distributing leaflets for or against any candidate for public office; or
- Organize a campaign against or in support of any candidate for public office or a political party before elections.

(3) Where restrictions are applicable to political activities, these restrictions are applicable only to limited categories of NGOs. In common-law countries, for example, restrictions apply only to charities or tax-exempt organizations. All other categories of NGOs are fully free to engage in political activities. In the civil-law context, restrictions may also be imposed where the NGO is pursuing public benefit or tax-privileged purposes. And in some cases, certain categories of NGOs, such as foundations or public benefit organizations, are prohibited from engaging in “party political” activities, such as nominating candidates for office, campaigning, or funding parties or political candidates.

(4) NGOs are subject to no special restrictions regarding foreign funding, beyond those rules that are generally applicable to all legal entities (e.g., rules relating to money laundering).

(5) NGOs engaged in political activities (however defined) are not subject to any specific notification or reporting requirements relating to political activities.

NGOs in the Political Realm

**NGOs:
An Antibiotic Against Bureaucracy,
Democracy's Degenerative Illness**

Eduardo Szazi¹

1. General Overview

The strong democratic winds that have been sweeping the world since 1989 have ushered in an unprecedented situation, in which electoral democracies now constitute the predominant form of government in the world. They have also given birth to a steady increase in the people's participation in public affairs, either at the national or international levels, through private bodies, the so-called non-governmental organizations (NGOs).

The expression "non-governmental organizations" was coined by the UN Charter, which, by establishing consultative procedures with NGOs (article 71), assumed that the public sphere was larger than the governmental one and that not only States had the legitimacy to be heard in matters affecting the needs and aspirations of citizens. This *hard law* recognition of the importance of NGOs was followed by several similar provisions in the constitutive acts of intergovernmental organizations, both at the universal or regional levels, in UN programs and funds, as well as in other innumerable *soft law* instruments of interaction between governmental bodies and NGOs.

Hence, one could affirm that, at the international level, pluralism is admitted by the UN Charter not only *between* States, but also *beyond* States, since the Charter acknowledged that individuals could interact with the United Nations not only through governmental organizations but also through *non-governmental* organizations. Some authors suggest that since 1945, the world has been living in a neo-Grotian era insofar as the principles of solidarity have been invigorated.² Not coincidentally, this is the same period in which we observed the appearance of NGOs, which experienced a particularly explosive growth after the adoption of the International Covenant of Civil and Political Rights (1966) and the end of the Cold War (1991), both pivotal moments for civil society at large. NGOs are new forms of people's participation in public affairs, which, at the international level, is based on the international legal personality of individuals and the right of people to self-determination, which has expanded way beyond the de-colonization process of the last century to encompass the right to democracy.

However, if democracy provides the contractual arrangement framework for the participation of people in public affairs through periodic elections, it is currently not capable of ensuring the same participation in the operation of the "social contract,"³ the Weberian bureaucracy that controls the State and has replaced parliament as the main norm-creator. Civil

¹ Eduardo Szazi is Professor of Law, Getulio Vargas Foundation, Brazil.

² R Jackson, *The Global Covenant: Human Conduct in a World of States* (OUP, Oxford, 2000), 385.

³ J Locke, *Two Treatises of Government*, 2nd Treatise, Chapter VIII (Rethinking the Western Tradition series, Yale University Press, New Haven, 2003), 142.

society must control the State. Liberalism has adopted rationalism to ensure fundamental freedoms, hence, it is civil society that commands the State and not the other way around. The primacy of individual rights over State rights was acknowledged by international law when it accepted restrictions to the States' sovereignty if this proved necessary to ensure human rights. Hence, bearing in mind Thomas Franck's ideas on Democratic Governance,⁴ it is necessary to add another building block to his model, through mechanisms of civil participation to hold bureaucracy accountable for its acts and decisions.

One aspect merits attention: Even in solid democracies, while NGOs cannot be regarded as being *equal* to civil society,⁵ they are relevant non-state actors in the contemporary world that have demonstrated a great capacity for gathering collaborators and financial supporters.⁶ Any survey will show that NGOs are actively involved in the shaping of public policies, whether at a local, national, or international level, addressing a broad range of issues, sometimes as supporters but also—and more often—as critics.⁷

At the domestic level, NGOs are energizing the public sphere and improving the pluralist debate within the States in order to ensure the best fulfillment of the “social contract.” In several States, public policies are now being discussed between State officials and civil society representatives in official *fora*, such as thematic councils and cyclical conferences.⁸ NGOs can encourage local political processes that support democracy with the purpose to strengthen civil society in general, without becoming partisan in a political party's sense.⁹ Fostering such civil participation in the public arena is essential for the health of democracy: it ensures the rights of freedom of thought and participation in public affairs remaining aligned with the rational-legal structure of the State. It preserves the structure while it improves it. Moreover, it allows an effective counterbalance against self-oriented bureaucracies that might undermine democracy. Such measures have proven their efficiency by destroying the most powerful *bureaucracy* of the 20th century: the Soviet Union.¹⁰

⁴ T Franck, *The Emerging Right to Democratic Governance* (1992) AJIL v 86, 50.

⁵ For a critical commentary on the belief that international NGOs constitute a kind of international civil society, see K Anderson, “The Ottawa Convention Banning Landmines, the Role of International Non-governmental Organizations and the Idea of International Civil Society” (2000) EJIL v 11 n 1, 91.

⁶ A remarkable aspect is nonprofit sector employment as a percent of total nonagricultural employment. A research study released in 1998 identified that 12.4% of Dutch employees were working for nonprofit organizations, this being the highest rate among the 22 countries under study. See L Salomon and HK Anheiner, *The Emerging Sector Revisited: A Summary* (Johns Hopkins Institute for Policy Studies, Baltimore, 1998).

⁷ The implications of an often witnessed situation—where NGOs start working as “watchdogs” to become “working dogs” under financial agreements—regarding the capacity of NGOs to remain independent from the state, has been addressed at the UK national level. See, D Morris, *Charities and the Contract Culture: Partners or Contractors? Law and Practice in Conflict* (Charity Law Unit, Liverpool, 1999).

⁸ In Brazil, for example, several issues such as Health, Education, Environmental Protection, Social Security, Childhood and Elderly Protection, and Tourism have their decision-making, monitoring, and implementation processes executed through thematic councils maintaining equal representation of State and civil society.

⁹ A Clayton (ed.), *Governance, Democracy and Conditionality: What role for NGOs?* (Intrac, Oxford, 1994), 117.

¹⁰ How could such a bureaucratic stronghold fall without a single shot having been fired? The answer is simple: democracy.

That is why, in our opinion, some States' bureaucracies desperately want to control NGOs.

2. State Bureaucracy: democracy's degenerative illness?

States, as abstract bodies, cannot operate by themselves. They need to be structured, and for that purpose, together with the creation of the modern State, bureaucracy flourished. Hegel's *Philosophy of Right* dedicated considerable efforts to justifying the desirability of a "universal" class of civil servants to provide the organic character of a legal order, the State, sowing the seed that would later grow in Weber's work, who once wrote that

Experience tends universally to show that the purely bureaucratic type of administrative organization is, from a purely technical point of view, capable of attaining the highest degree of efficiency and is in this sense formally the most rational known means of carrying out imperative control over human beings.¹¹

When Weber wrote his seminal book on the economic and social order, he was impacted by the transformations that were occurring in Russia and, particularly, in Germany at the beginning of the 20th century. He was unable to foresee that the rational-legal machinery that he had so precisely conceptualized would degenerate in his homeland to such an extent that it would be able to *bureaucratically* control the murder of millions of people, including German citizens, as described by Hannah Arendt.¹²

However, Weber's perception of the power of bureaucracies is noteworthy: when asked how those subjected to bureaucratic control could seek to escape from its apparatus, he answered that this would happen "normally" by their establishing an organization of their own, which would be equally subjected to the process of bureaucratization!

Although apparently outrageous, his assertion has found an echo in reality: when a large group of people decide to challenge the apparatus of one State, they create another State; when a small group decides to do so, they create an NGO. Regardless of this, there is an aspect of Weber's theory that cannot go unnoticed: the undeniable purpose of bureaucracy is *control*, which is exercised on the basis of knowledge. He makes no reference to any other relevant purpose.

If the purpose of bureaucracy is control, then, in order to avoid its degeneration, it is fundamental to control the controller and this can be done only to the extent that people possess the power to enforce the fulfillment of the "social contract" entered into with the States. It is only possible in democracy and, moreover, in those democratic regimes that have adopted mechanisms of civil participation.

If civil society cannot hold States' bureaucracies accountable for their decisions, relying on loose controls established by the State itself,¹³ that control will be nothing more than a formal, fictional and ineffective one, giving room to democracy's degeneration.

¹¹ M Weber, *The Theory of Social and Economic Organization* (The Free Press, New York, 1964), 337.

¹² H Arendt, *Eichmann in Jerusalem: a Report on the Banality of Evil* (Penguin, New York, 1992).

¹³ These practices vary from State to State and comprise, for instance, the Executive budget's control by the Parliament, External Oversight governmental bodies and the publication of budget and execution reports in official gazettes or their posting on the internet, just to name a few. The problem with all these mechanisms is their

Schumpeter said that

Revolution need not mean an attempt by a minority to impose its will upon a recalcitrant people; it may mean no more than the removal of obstructions opposed to the will of the people by outworn institutions controlled by groups interested in their preservation.¹⁴

3. NGOs: an antibiotic against democracy's degenerative illness?

Democracy has become the political orthodoxy, and some are tempted to say, the political religion of the West.¹⁵ But, democracy is a method¹⁶ and if it is the only existing remedy to protect the abstract States and respective "social contracts" with their nations against the illnesses caused by self-oriented bureaucracies, then it is important to appraise what instruments are at our disposal. The parliament is the classical antibiotic, but it is losing effectiveness. For that reason, it is important to enhance the performance of the immunological system with a new, fourth generation of "participatory rights." McDougal and Reisman argued that

The core demand for the availability of genuine individual participation [in public affairs] may be made comprehensively explicit in an overriding policy of inclusivity.¹⁷

NGOs have provided evidence that they are structures capable of increasing political density in societies, fostering the plurality of ideas and debate, exercising oversight and monitoring the bureaucracy. As phrased by Lindahl, "who is affected and what is the problem to be solved are matters of substance that require deliberation, yet deliberation cannot kick off without a prior determination of the members and the problem of the deliberative body."¹⁸ If democratic governance requires continuous improvement, then it is necessary to appraise who is making the decisions, a task that necessarily drives our mind back to bureaucracy and its control.

Individualism is a key element in liberal thought. The more individual freedoms a given regime has, the more liberal it is; the more *sovereign* the people, the more liberal the State. It follows that liberal individualism is expressed in the realm of law in the form of fundamental freedoms and rights and democratic participation in the decision-making processes of public affairs. Hence, to add a fourth building block to Franck's "right to democratic governance," it is necessary to remove "obstructions opposed to the will of the people by outworn institutions," a measure which necessarily takes into account accepting the fact that new antibiotics must be widely used.

When Franck presented his building-block theory on the right to democratic governance, he focused on democratic elections, which imply choosing hundreds of thousands of peoples' representatives to the parliaments around the world and, comparably, a handful of Heads of State in presidential republics. But, as is well-known, rule-making is mostly concentrated in the hands

emphasis on cash (which definitely is important) and their frequent incapacity to ensure that, albeit expended according to the norms, these resources have been used in order to effectively fulfill the covenant.

¹⁴ J A Schumpeter, *Capitalism, Socialism and Democracy* (Harper, New York, 1975), 236.

¹⁵ R Jackson, *The Global Covenant: Human Conduct in a World of States* (OUP, Oxford, 2000), 340.

¹⁶ J A Schumpeter, *Capitalism, Socialism and Democracy* (n 13), 242.

¹⁷ MS McDougal and WM Reisman, *International Law Essays: A Supplement to International Law in Contemporary Perspective* (Foundation Press, New York, 1981), 201.

¹⁸ H Lindahl, "Sovereignty and Representation in the European Union" in N Walker (ed.) *Sovereignty in Transition* (Hart, Oxford, 2003), 93.

of bureaucrats, following that the major *condotieri* of public affairs do not have, themselves, a democratic pedigree.

If one compares NGOs to bureaucracy, remarkable differences can be observed. Large NGOs, for instance, can reach thousands, even millions, of supporters. These civil society roots imply transparency and accountability, simply because NGOs traditionally depend on private funding. If individuals are not satisfied with the performance of a given NGO, they will not contribute to it or volunteer to participate in its activities, and the entity will suffer. Of course, one can argue that NGOs' transparency and accountability is not that good and that it demands improvement. Yes, that is right, and, fortunately, such criticism evidences the strength of NGOs: the more an organization represents people, the more it is scrutinized. No one would care about accountability if representativeness were not at stake. These are the two sides of the same coin. This duality is the very reason for NGO criticism to a State's lack of transparency and accountability, or, in more common words, "democratic deficit." If States are in charge of delivering "services" to people, they have to be held accountable.

Bureaucracy often claims that NGOs were not elected by the people. In a narrow interpretation of an "election" as a cyclical democratic process where people go to the polls to choose representatives within a set of candidates, this is unequivocally true. But, if one interprets elected as supported by a large group of people, the result is different.

The International Covenant of Civil and Political Rights, for instance, ensured to every citizen, without distinctions of any kind and without unreasonable restrictions, the right and opportunity to take part in the conduct of public affairs, directly or through freely chosen representatives (article 25). If the Covenant ensured the right to direct participation in public affairs, which can be performed by freely chosen representatives, without unreasonable restrictions, then, *international law does not impose any limitations whatsoever that such participation be carried out through NGOs.*¹⁹

Democracy necessarily requires the engagement of several constituencies presenting their opinions and debating the issue at stake. The NGOs' role is to enhance the debate with different points of view, concerns, and alternative models, qualifying the decision that will be made by the State's bureaucracy. However, participatory rights are not enough, because NGOs are closer to the people than any State. The improvement of the right to democratic governance requires access to information with the purpose of holding those who have made the decisions or executed them accountable for their performance.

And it is precisely to avoid such accountability that some States' bureaucracies have taken legislative actions to regulate the nature and scope of NGOs' activities.

4. Turnstiles: an antidote to antibiotics?

Would it be possible to counter the effects of antibiotics with turnstiles? I doubt any doctor would say so. However, in a legal sphere, that it is exactly what some States' bureaucracies are trying to do, by enacting measures attempting to limit NGOs' work. Fortunately, it doesn't seem like such remedies will succeed as long as democracy is enshrined in the souls and hearts of people.

¹⁹ Along the same lines of our claim, see J Crawford, "Democracy and the Body of International Law, in GH Fox and BR Roth, *Democratic Governance and International Law* (CUP, Cambridge, 2000), 91.

A brief survey of the legal framework of major Latin America and Caribbean countries will show that freedom of association is guaranteed by the Constitution in Argentina, Brazil, Chile, Colombia, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, San Domingo, Uruguay, and Venezuela. However, the freedom of association is not absolute, because all States can exercise control over the legal entities and individuals that are within their boundaries, appraising to what extent they are complying with the Law.

One must understand such control as necessary. As a result of the 11 September attacks, certain malfeasance practices came to light, in which charitable fundraising and institutions had been used as coverage for financing terrorism, which included shelter to terrorists, logistical support, and illicit weapons. Those circumstances led the OECD Financial Action Task Force on Money Laundering (FATF-GAFI) to study and propose international best practices to combat the abuse of non-profit organizations, focusing on their financial transparency, programmatic verification, administration, oversight bodies, and sanctions.²⁰

However, considering that Latin American bureaucratic culture and overwhelming structures can prolifically enact an extensive net of often dubious norms, capable of entangling even the most organized and serious entity, NGOs can easily be declared non-compliant entities and, therefore, submitted to heavy penalties and administrative measures, including the suspension of their operations.

An example of what may become an insidious trap is the widely observed periodic renewal of accreditation before public bodies, often a prerequisite for tax exemptions. Once the NGO fails to renew its accreditation, its tax benefit is cancelled and past taxes become due immediately, with heavy penalties. A similar practice can be observed with regards to international NGOs, which in the eyes of old-fashioned leftist governmental officials also carry the burden of being instruments of foreign interference in the country's internal affairs (see, for example, the triennial renewal in Bolivia and Ecuador).

Hence, if one acknowledges that either NGOs or terrorist groups have roots in civil society and, also, in their supporters' dissatisfaction with the world's current state of affairs and/or government strategies to deal with them, it is therefore important to implement a set of rules and procedures capable of enhancing civil participation in policy decision-making processes in order to address the manifold issues at stake and counterbalance the appealing "The end justifies the means!" call of certain groups before the deafness (disdain?) of States.

5. A wise treatment: democratic control

Some Latin American countries have understood the contemporary challenge and enacted new legislation focused either on democratic control and access to policy making in a clear attempt to compromise all needs at stake. This was the case of Colombia²¹ in 2001, Mexico²² in 2000, and Brazil in 1999.

²⁰ FATF-GAFI, *Combating the Abuse of Non-Profit Organizations: International Best Practices* (report) (11 October 2002) < <http://www.fatf-gafi.org/dataoecd/39/19/34033761.pdf> > accessed 21 August 2009.

²¹ Law 720, of 29 December 2001, addressing the involvement of citizens in public affairs through voluntary work (Ley por medio de la cual se reconoce, promueve y regula la acción voluntaria de los ciudadanos colombianos).

Brazil, after a comprehensive survey on the shortcomings of the legislation concerning NGOs involved in broad consultation with civil society, enacted a law qualifying NGOs as Public Interest Civil Society Organizations (commonly known by the Portuguese acronym OSCIP).

According to the law, the qualification will be given to private law, nonprofit legal entities whose purposes comprehend public interest objectives such as social welfare, culture, education, health, environmental protection, economic, and social development, human rights, peace, and democracy, provided that the considered entity's statutes and bylaws have clear rules with regard to

1. The observance of the principles of legality, impersonality, morality, public disclosure, economy, and efficiency;
2. The adoption of managerial practices necessary and sufficient to prevent individuals or groups that participate in the respective decision-making processes from obtaining benefits or personal advantages;
3. The establishment of an Audit Committee or equivalent body with the power to comment on financial and accounting activity reports and on operations carried out with an organization's assets, including the power to submit written and oral opinions to the higher bodies in the organization;
4. The provision that, in the event that the organization is dissolved, its net assets be transferred to another legal entity holding the status described in the Law;
5. The provision that, in the event that the legal entity loses its status, as established by the Law, the assets acquired with public resources during the period in which said status was in effect be transferred to another legal entity holding the status described in the Law;
6. The possibility of establishing remuneration for officers who effectively manage the entity and for those persons who provide specific services to it, provided that in both cases the said remuneration be limited to the market rate in the entity's respective region and operational area;
7. Publicly disseminating, by any efficient means, a report of the organization's activities and its financial statements, including certification of no outstanding social security debts, at the end of each fiscal year, to be available for examination by any citizen;
8. Conducting an audit by outside, independent auditors, in those situations where public resources funded the activities of the organization.

Also according to the law, the qualification may be lost following a request for or the decision of an administrative or judicial proceeding, originating either from a popular initiative or with the Public Attorney, with the right to ample defense ensured. If solid indications of misuse of public resources or assets arise, the Public Attorney and the Federal Solicitor

²² Law of 23 May 2000, addressing the fostering of social development activities of civil society organizations (LEY DE FOMENTO A LAS ACTIVIDADES DE DESARROLLO SOCIAL DE LAS ORGANIZACIONES CIVILES PARA EL DISTRITO FEDERAL).

General's Office may act and request a court order to freeze the assets of the entity as well as those of its officers and any public agents or third parties who may have illegally enriched themselves or otherwise harmed the public treasury.

The OSCIP law, briefly outlined above, together with the quoted Colombian and Mexican initiatives, provide evidence that there is plenty of room for improvement in the legal framework of Latin America and the Caribbean in circumstances that can address either the need for public scrutiny of NGOs or the right to public participation, through NGOs, in the conduct of public affairs, holding bureaucracy accountable for their acts in the eyes of civil society and enforcing the entitlement to democratic governance beyond the fallacious social speech of Bolivarianism.

It is always worth remembering that democratic governments represent civil society but cannot be regarded as its substitute, because the principles enshrined in the UN Charter admitted pluralism *beyond* States, through *non*-governmental organizations. Any attempt to silence NGOs is a threat to civil society and must be fiercely fought, or democracy will be killed.

Article

Citizen Participation in Mexico Through Advisory Councils

Consuelo Castro¹

In Mexico, one mechanism that has been instrumental in the past few years in order to maintain a government-civil society relationship is the government Advisory Councils, in which CSO representatives participate.

The *Federal Law for Promotion of Activities Performed by Civil Society Organizations*, enacted five years ago in order to have a regulatory framework to sustain a stimulating policy for actions undertaken by CSOs, is not an exception. This Law established two important entities: the *Commission for the Promotion of Activities Performed by Civil Society Organizations* and the *Technical Advisory Council for the Law of Promotion* (Consejo Técnico Consultivo—CTC). The first, the *Commission for Promotion of Activities Performed by Civil Society Organizations*, is composed of representatives from four ministries: the Secretaría de Hacienda y Crédito Público – SHCP (*Secretariat of the Treasury and Public Credit*), Secretaría de Gobernación – SEGOB (*Secretariat of the Interior*), Secretaría de Desarrollo Social – SEDESOL (*Secretariat of Social Development*) through its Instituto Nacional de Desarrollo Social – INDESOL (*National Institute of Social Development*), and Secretaría de Relaciones Exteriores (*Secretariat of Foreign Affairs*). The other entity created by the Law on Promotion, the *Technical Advisory Council*, hereinafter referred to as “the Council,” is a participatory body for civil society organizations. The Council became effective on January 17, 2005, and consists of nine CSO representatives, plus four members from the academic, professional, scientific, and cultural sectors, as well as two Congress representatives. Members and their substitutes are appointed for a three-year term of office.²

According to its regulations, the main purpose of the Council is to issue proposals and recommendations regarding the CSO Registry, as well as to jointly coordinate with the government Commission on the evaluation of promotional policies and actions for CSOs on an annual basis.³ The Council also issues opinions concerning the application of the Law on Promotion and promotes civil society participation, especially through the follow-up of public policies. In order to carry out its functions, the Council has formed committees in various topic such as public policy, organizations registry, legal, communication, professionalization.⁴

In order to evaluate the impact of public policies concerning CSOs, having reliable data is fundamental. Before the Law on Promotion, there was no consistent effort to integrate

¹ Consuelo Castro is Legal Director at the Mexican Center for Philanthropy (CEMEFI), a member of the Technical Advisory Council, and a member of the Advisory Council of the International Center for Not-for-Profit Law.

² The author has been a member of this Council since 2008.

³ See Law on Promotion § 26 and § 28.

⁴ Subject matter for the CTC can be found at www.consejotecnicoconsultivo.org.mx and www.corresponsabilidad.gob.mx.

information on public administration support to CSOs. Therefore, in 2005 an Annual Report was integrated for the first time in Mexico on this matter by the Secretariat of Social Development (INDESOL). For instance, in 2008, the Annual Report included the report of 126 public officers from 17 Secretariats and 53 Governmental units. Promotion activities reported include public resources funds, capacity-building training, organization of events, and others. However, the relevance of these reports consists in making concrete actions for public disclosure of subsidies and other support received by CSOs.

Nevertheless, based on the results of these Annual Reports,⁵ the Advisory Council will have more elements to encourage the government to define the activities of nonprofit organizations. It is important to point out that it is beginning to help government agencies to have better coordination regarding nonprofit organizations and influence the efforts to consolidate an effective public policy of promotion of CSOs. Collecting evaluation reports from the governmental administration authorities has not been an easy process as it implies that the different ministries do not have common terms of reference concerning CSOs. Therefore, although the reports have been improved each year, it is not yet possible to have accurate information on the way the application of public policies concerning CSOs have had an impact on CSOs.

The approval of the Promotion law not only focuses on having better public policies towards CSOs; the purpose of the Law is to recognize organized participation of citizens in fields of action such as human rights, gender equity, and development of the community. One of the results expected of this Law is also to serve as a platform for incentives other than having access to public funds such as fiscal exemptions.

In 2005, based on the Law on Promotion, the Council successfully advocated jointly with other organizations such as the Mexican Center for Philanthropy (Centro Mexicano para la Filantropía – CEMEFI) in order to have human rights organizations be eligible to receive tax-deductible donations by fiscal authorities according to Mexican tax legislation. Recently, organizations dedicated to promote civic activities may also be tax exempt. Having tax incentives opens possibilities to this type of organizations to access more public support and help their sustainability.⁶ The legal committee of the Council has reached a consensus with organizations on legal reform proposals to fiscal authorities that would facilitate donations such as the need to increase the 7% limit of taxable income that may be deducted established in the 2007 Fiscal Reform.

After four years, the Council faces various challenges. One is to have a budget to cover activities relating to the overall service, research, publication, and other tasks. Usually the scarce funds assigned are delivered late in the fiscal year. Another challenge is to have access to more communication mechanisms with civil society organizations that will enable a closer dialogue with nonprofit organizations throughout the country.

However, though Councils such as the *Technical Advisory Council for the Law of Promotion* have been recently created, a formal and permanent dialog with the federal government and civil society organizations has been taking place. The main objective of the

⁵ http://www.corresponsabilidad.gob.mx/inf_anual_depe.aspx.

⁶ Income Tax Law Reform published in December 23, 2005 at the Official Journal.

Council is to be able to participate in the design, follow-up, and assessment of public policies. Up to now, the results show that although the Technical Advisory Council has limitations to effectively influence public policy, it has a significant role as a liaison with the federal government.

Article

State Supervision of NGOs in Perú

María Beatriz Parodi Luna¹

General Context

At the moment in different countries of Latin America, we again encounter challenges derived from the State's questioning the performance of Civil Society Organizations (CSOs), especially those that receive International Technical Cooperation, denominated Non-Governmental Organizations (NGOs), because of the use and management of such resources toward projects of "*public or social interest.*"

Perú is not apart from this general context, therefore, modifications were made in existing legal norms on December 2006, specifically in the Agencia Peruana de Cooperación Internacional (Peruvian Agency for International Cooperation—APCI), destined to establish mechanisms of supervision and control in relation to the activities of such organizations. Such legal reforms generated public debate about political and judicial reaches, which translated into an action presented before the Peruvian Constitutional Tribunal by an important number of citizens (more than 8,000), and headed by NGOs. Its ruling was issued in August 2007.

Furthermore, recently, the debate has been brought back to life, with attempts at approving legal norms (new modifications to the norms of APCI) that contradict or in a different way violate the juridical analysis and pronouncements of the Constitutional Tribunal of Perú. The said reforms are given under the justification that the activities of NGOs "are linked to development and national security" and/or have to do with activities of "national interest" referring to such topics as education, health, defense, national security, internal order, and human rights; and therefore they require the presence of the State/Government.

So, in general terms, this topic poses central questions: *What should be the role of the State in respect to CSOs, specifically in the case of NGOs? How can we achieve an "adequate" balance between transparency of CSOs and the supervision of the State?*

II. GENERAL LEGAL FRAMEWORK IN PERÚ

2.1. Legal status of NGOs in Perú

In Perú, as in many countries of Latin America, NGOs are not a special type of legal entity. They are formally constituted under the legal forms of association and foundation (regulated by the Civil Code), of which the more common in Perú is the association because of the flexibility of its regulation.²

¹ María Beatriz Parodi Luna is an Attorney; a Partner of BP& MN, Legal Consultants; and a member of the Advisory Council of ICNL.

² In the case of Perú, foundations are regulated in the Civil Code, but the State limits their flexibility and control through the Consejo de Supervigilancia de Fundaciones (Supervision Council of Foundations), which inclusively adopts certain decisions linked with the approval of balances and budgets as well as acts of disposition of

The name “NGO” in Peruvian legislation refers to an “administrative qualification” derived from the Register denominated “Registro de Organizaciones No Gubernamentales de Desarrollo Receptoras de Cooperación Técnica Internacional (ONGD-PERU),” constituted in Perú. At the moment this registry is under the management of APCI, which is the State’s entity of International Technical Cooperation appointed within the Ministry of Foreign Relations.

The Ley de Cooperación Técnica Internacional: Act of International Technical Cooperation (Legislative Decree N° 719) of Perú establishes that these organizations are characterized by their purpose of non-profit and for carrying out development activities that involve international technical cooperation in one or more of the modes indicated by that Law. This means that not all types of non-profit legal entities (associations or foundations) constituted in Perú can be listed in the Administrative Register—only those that:

- (i) carry out development programs or projects and
- (ii) channel international technical cooperation.

An organization’s listing in the administrative Register is valid during a two-year period and is renewable. It requires an annual presentation of the pertinent report related to the activities carried out, indicating the projects or activities to which resources of each cooperating source were destined. Application also requires the information related to the next two years, when the renewal will be applied for (further information: www.apci.gob.pe).

2.2. General context of the relation State-NGO in the last years

The Peruvian Civil Code regulates civil associations in a very flexible and perhaps terse way (there are only 19 articles). At the same time, when actions involve International Technical Cooperation, a specific regulation exists linked to an administrative register kept by APCI.

In the case of NGOs there is not, in general, a specific regulation in relation to the type of economical, political, or lobbying activities that these types of entities may carry out; or an obligation to render balances or other types of financial documents. Therefore, the range of activities that NGOs can carry out is quite wide, if the following general legal limits are respected: (i) the non-profit purpose that characterizes these associations is not violated; (ii) the activities are those that are in or derived from the purpose; (iii) no attempts against public order, moral customs or imperative norms are made. Also no specific regulations exist in relation to the composition of directive organs of these organizations or conflicts of interest.

On the other hand, during the last years in Perú there have been several attempts to supervise or control the activity and, more specifically, the use of NGO resources, in some cases with proposals to establish even limits to the remunerations of the directors, considering, in our judgment wrongly, that these violated the non-profit purpose that characterized these types of organizations. In our consideration there is no legal prohibition against an associate or director of an association, who carries out and effective work or services on behalf of the association, receiving payment, in accordance with the prices of the market. During the 1990s, corresponding with Fujimori’s government, although he maintained hostile relations against NGOs, especially in the field of human rights and defense of democracy, this did not translate into an

property that do not constitute ordinary operations of the Foundation. Also founders (“promoters”) do not participate in the foundation unless they act as administrators.

establishment of legal norms destined to their control; rather, the same legal system continued at the level of the Civil Code and especially the International Technical Cooperation legislation. On the other hand, legal norms that promoted their performance were not granted—specifically, more tax incentives.

Within this legal context and general situation, it is important to take note of the promotional and innovating role of NGOs: especially to cover the spaces where the State has not wanted or has not been able to enter. In this way, we can attribute to CSOs and NGOs the following contributions: (i) provision of “public” services or of social aid in areas like urban or rural development (and especially contributing to the generation of their own resources via sustained economical activities), microfinance, education, and health; (ii) innovation; (iii) advocacy or public attention to problems and promotion of change, in such areas as transparent elections, human rights, and gender equality; (iv) creation of leaders; and (v) strengthening of democracy and the civil society.³

In spite of such strengths, an important limitation or weakness within the legal framework in Perú relates to the “render of accounts” (accountability) of CSOs in general. Although the most important NGOs, in terms of public recognition or institutional trajectory, have developed mechanisms of transparency (they secure registration in APCI’s NGOs Register and, because of this, they periodically present their plans and projects to the said entity; they keep accounting and balances up to date; they have developed public information mechanisms, such as through Web pages), *“the majority of these entities have not developed trustable or durable render of accounts mechanisms, the problem seems to be associated to the characteristics of the Peruvian Society in general.”*⁴

In effect, many NGOs act according to specific projects, heeding the rules of the exterior cooperating sources, and, therefore, have not developed general institutional character guidelines. Equally, the mechanisms of control are wielded by the directors and/or associates. Therefore, there exists no precise and generalized recognition of the importance to create mechanisms of supervision and render of accounts that will contribute to their institutional strengthening, beyond the mechanisms of render of accounts, presentation of reports, or similar requirements imposed by agreements of their cooperating sources for particular projects.

3. CONTENTS AND INTENTIONS OF THE LEGAL REFORMS CARRIED OUT IN PERÚ

The weakness or issue regarding the render of accounts in Perú has been used by the State to justify the legal modifications for controlling their activities. So has the general principle contained in the Political Constitution of Perú that the *“State directs the development of the country.”*

It is important to point out that such legal modifications have been given specifically in relation to the management of Non-Reimbursable International Cooperation (donations or

³ Criteria taken from the book “Más allá del individualismo: el tercer sector en el Perú” Autores: Portocarrero, Felipe; Cynthia Sanborn; Hanny Cueva y Armando Millán.

⁴ “Más allá del Individualismo,” page 261.

grants), which indicates the State's interest in controlling these resources in order to “*defend the public interest and the promotion of national development.*”

In December 2006, Law 28925 was enacted, which is not a modification of the general Ley General de Cooperación Técnica Internacional (General International Technical Cooperation Act), Legislative Decree Number 719, but rather a modification of the Agencia Peruana de Cooperación Internacional (Peruvian Agency for International Cooperation) APCI Law number 27692. The new law sought to strengthen the functions of the entity and the mandatory character of the administrative registers in its charge.

The legal modification was the object of a series of criticisms, especially regarding the violation of the fundamental rights of freedom of association, contracting, and privacy. In spite of a series of adjustments, the fundamentals of the Law were maintained and, inclusively, the Bylaws of Infractions and Sanctions were enacted.

Which were the main modifications of Law Number 28925 that amount to an unconstitutional demand?

- 3.1. First, the said Law reinforces APCI's object, as overseer of international cooperation, not only establishing the conduct, programming, organizing, and supervising of the management of Non-Reimbursable International Cooperation (donations or grants), **but establishing as a function to “give priority” to technical cooperation, “according to the function of national development.”** This is one of the central aspects that was questioned, because it clearly intervenes in private legal relations – as far as the State does not participate or there is no transference of state resources – in the agreements between the cooperative sources and NGOs, as executors, and where are established, based on the autonomy of free will, the field of action of the projects, promises of the parties, render of account mechanisms, and other aspects of a private contractual regulation.
- 3.2. In principle, the norm is applied to all entities (it does not say only NGOs) that manage international cooperation with the participation of organisms of the State, **but later on, it includes those entities that make use of some privilege or tax benefit, that use “in some way” state resources, or that operate in a cooperative entity that includes the State.**
- 3.3. The norm “for the purpose of transparency” also requires other entities that manage international cooperation to register in a special Register created by APCI, of a public and informative character, where each project, program, or activity should be identified.

In defense of this point, APCI has indicated that the Register requirements (published on the web: www.apci.gob.pe) are very general, and therefore no reason exists to justify the opposition of NGOs to make their projects public, given the virtues of transparency. But if the requirements are very general today, nothing prevents more far-reaching requirements from being implemented in the future, opening the door to an unjustified State intervention in an essentially private activity. The necessary transparency—that nobody denies—cannot have, by essence, a compulsive origin.
- 3.4. It is established, for entities included in the Law, the mandatory inscription in the NGO Non-Governmental Development Organizations Register (“Registro de Organizaciones No Gubernamentales de Desarrollo Nacionales receptoras de Cooperación Técnica

Internacional”) for entities constituted in Perú. In the case of entities constituted abroad, the Registry of Foreign Entities and Institutions of International Technical Cooperation (“Registro Nacional de Entidades e Instituciones Extranjeras de Cooperación Internacional-ENIEX”) is applicable. For executing international technical cooperation, the inscription in these Registers is an obligation, independently of the juridical nature of the cooperating source as it is expressed in the modification, which was later interpreted in an important way by the Constitutional Tribunal. Not to be registered or renewed in the Registers has been deemed an infraction subject to an administrative admonition, a fine, temporary suspension of the benefits granted by the Register (referring fundamentally to income tax and sales or purchase tax in the acquisition of goods or services), and cancelation of listing in the Register.

- 3.5 The law effectively intimidates the persons linked to the administration of an NGO, including consultants, because it establishes that “*the director, administrator, consultant, legal representative or agent of the entity to which the inscription in the said registers has been canceled, cannot participate directly nor indirectly in another entity executor of international technical cooperation during a term of five years.*”
- 3.6. Finally, as a relevant aspect of this legal norm, special attention should be paid to one punishable infraction: the “*orientation of the resources of International Technical Cooperation towards activities that affect public order or public or private property.*” As we know, what affects public order or public or private property may easily be interpreted or adapted in accordance with the interests of a given Administration.

It is also included as a punishable infraction to “*make wrongful use of the resources and donations of international technical cooperation or apply these for different purposes to those for which they were granted.*” This infraction is invasive of private relations (private agreements).

4. THE UNCONSTITUTIONAL ACTION

4.1. Antecedents

In response to the enactment of Law Number 28925, a group of important citizens (more than 8,000), headed by representatives of NGOs, in 2007 lodged an action challenging the legal norm’s constitutionality before the Constitutional Tribunal of Perú. The court in August 2007 declared the demand partially founded. But most important are the interpretations granted by the Constitutional Tribunal in relation to the role of the State and to the concept of transparency for these entities.

The objective of the unconstitutionality action was not to question the necessity of transparency, including the inscription in the NGOs Register in charge of APCI, which has existed for many years, or the presentation of reports. In fact, many NGOs are registered with APCI, and they present their project reports, cooperating sources, and other information required by APCI. What was fundamentally questioned was the mandatory nature of such a register imposed by the State with implied sanctions, when an objective cause does not exist, just as before when it was interpreted that such a register was mandatory when the cooperation was channeled through the State. At the same level, it is questioned as an unjustified “public function” APCI’s faculty of establishing what a “priority” is and the consequent establishment of

punishable infractions of certain conduct arising in the private relations between cooperating sources and the NGO.

It is important to note that the constitutional challenge alleged that the legal norm violated several principles and/or constitutional rights, also sustained in international treaties signed by Perú, which in brief are: (i) **constitutional principle of equal rights**, which demands “equal treatment to equals, but unequal to those unequal,” in accordance to Article 2, subsection 2 of the Political Constitution of Perú; (ii) **right to a private life or “privacy”** of NGOs that receive International Technical Cooperation (ITC) and do not receive any type of State or tax benefit or exemptions, when obligated to register their programs, projects, and activities along with the execution of their expenses in a public registry with APCI; (iii) **right to freedom of contracting**, because the mentioned Law authorizes the Public Administration to “give priority” to the destination of ITC private funds, ignoring the aims and specific projects to which the donor, in the use of his right of contracting and autonomy of will, has decided to destine his resources, as expressed in a contractual agreement that could inclusively be ruled by a foreign legislation; (iv) **freedom of association**, and as a consequence of this, also the **right of participation in the political, economical, social, and cultural life of the nation**, when the entities of ITC are required to register in diverse administrative registers, as a condition of executing their projects, programs, and activities.

4.2. The Ruling—Lessons to Point Out.

On August 29, 2007, the Constitutional Tribunal of Perú pronounced its ruling (www.tc.gob.pe) on the demand of unconstitutionality above indicated. Far more than just declaring partially founded the lawsuit on two specific points, it is an interpretative ruling of value and importance. This is the case not only from the legal point of view, but also in terms of social-political analysis with regard to CSOs (specifically in this case NGOs) and their relation with the state, as well as the “public role” that these entities fulfill.

The court indicated, with regard to the administrative register kept by APCI, that “(...) *it should follow the constitutional directive that permits the restructure of the balance between what is public and what is private, between freedom and authority, between private initiative and imposed power of the State, according to an adequate flexibility that accentuates the democratic conception of the state ordinance*” (Fundament 38).

In this respect, the ruling of the Constitutional Tribunal excludes from the Peruvian Legal System as unconstitutional two specific aspects of the questioned Law, namely:

- a) The part imposing a requirement to report the execution of expenses that are made with the international private cooperating sources.
- b) The administrative punishment that, for an entity canceled in APCI’s administrative registers, prohibits certain individuals (director, manager, consultant, legal representative, or agent) from participating directly or indirectly in another entity of international cooperation, for the period of five years.

Without detriment of the above, what results most importantly from the ruling of the Constitutional Tribunal is the analysis of different topics, ranging from the relations between the model of social rights and the democratic State with Civil Society, up to the constitutional analysis of the administrative punishments linked to APCI’s registers.

4.3. **Principal Topics of the Ruling of the Constitutional Tribunal**

4.3.1. **International Technical Framework and the Role of NGOs**

In the first place, the court recognized the importance and development of all the civil society organizations, of which NGOs form part, as a special space, different from the State as well as from the market, whose potential is to be able to cooperate with the State supplying “social services” in areas where the State (public sector) or the enterprises (market sector) do not participate or are not involved, configuring in this way a “third sector,” but, at the same time, “**a private social sector.**”

Within this universe of CSOs, the ruling denominates NGOs as “*those non-governmental organizations that have for an objective to serve public interests mentioned by the render of specific services*” (Fundament 5).

NGOs also form part of the International Technical Cooperation System. In this respect, in accordance with the definition in the Peruvian Ley de Cooperación Tehnica Internacional (International Technical Cooperation Law) Decree Number 719, the Cooperation for Development or Official Help for Development or International Technical Cooperation (ITC) is understood as “*the means by which Perú receives, transfers and/or exchange human resources, goods, services, capital and technology from cooperating external sources whose objective is to complement and contribute to the national efforts in matters of development (...).*”

On the other hand, the Political Constitution of Perú recognizes subjective rights and objective interests that States should respect and guarantee to all people under their jurisdiction, in a framework of promoting “general welfare which is founded in justice and in the integral development and balance of the Nation” (Article 44). Thus, in this framework, NGOs contribute in the implementation of such purposes of the system and also in the full existence of the Social and Democratic State of Right.

As can be appreciated, although the private character of NGOs (which are legally civil associations or foundations) is recognized, these organizations play an important role within the system of International Technical Cooperation or Cooperation for Development, having, therefore, social solidarity or public interest purposes, which makes them different from entities that are purely private or commercial (in the case of enterprises).

4.3.2. **Obligation to be registered in the registers of the Peruvian International Cooperation Agency (APCI).**

In relation to the obligation of inscription in the administrative register of APCI, the constitutional challenge charged that the requirement violates constitutional rights of equality before the Law, private life, and freedom of association.

In this particular, the Sentence of the Constitutional Tribunal makes a valuable analysis and balance of this topic, arriving at very important conclusions, which are the following:

- a. In first place, in accordance with reiterated jurisprudence of the Peruvian Constitutional Tribunal, “*in the model of the State submitted to the normative and valuation force of the Constitution it does not fit to admit zones exempted from control, that in this case it is in charge of the public administration; without detriment, that in a supposed case of extreme exercise of such competence the said entities may appeal to the corresponding*

jurisdictional procedures – and subsidiary to the constitutional jurisdiction – so as to adopt objective and reasonable criteria” (Fundament 22).

This definition is very important in the present case, in which NGOs fulfill a social role that in a certain way complements or contributes with the State in “rendering social services.”

In attention to this, it is concluded that a “proportional” supervision by the Public Administration, in this case APCI, “*will ‘abound’ in strengthening the NGOs that act seriously in the sphere of the development, emergency help or environmental protection or that respect the interest segment of the poor or vulnerable population” (Fundament 22).*

The definition and application of the criteria of “proportionality” of the public administration (APCI, in this case) remain to be determined in relation to the sphere of supervision and inspection of NGOs that are inscribed in the registers, though the Constitutional Tribunal has explained and clarified the “mandatory” character of these administrative registers in charge of APCI.

But on the other hand, what is more important in the future, as something pending by the NGOs, is the establishment of guidelines of action that will permit a transparent performance, not only in front of the State, but in front of all the actors involved (cooperating sources, “beneficiaries,” society as a whole). These could be codes of conduct through networks or second-level NGOs, to which NGOs will adhere voluntarily.

- b. Another very important topic mentioned by the Constitutional Tribunal is the “mandatory” character of APCI’s registers.

In relation with this point, the Constitutional Tribunal established that the registers are not “mandatory” for all NGOs (be they national—ONGD Register—or foreign entities that open a branch office in Perú—ENIEX Register); so, in virtue of **their free will (this is, clearly the private character of this kind of organization), those that choose to do so, will register.**

Fundament 95 of the Ruling expresses the following:

*“First, because the inscription in APCI’s registers does not constitute a mandatory condition for the execution of ITC. As it emerges from the interpretation done by this Tribunal, the said obligation only corresponds to those that receive the patrimonial benefits, from the *ratione personae* of the refuted norm.*

“In consequence, the entities not registered in the sphere of their performance are not affected, but they are subject to the corresponding civil regime. With this interpretation the mandate of article 2 subsection 13 of the Constitution is saved, regarding the exercise of the right of association is not conditioned on obtaining a previous authorization; resulting that it is only necessary to obtain previous recognition as a legal entity to pursue the legal aims that motivated the association.”

That means that if an NGO does not want to access the regime of patrimonial or tax benefits that come with inscription in APCI’s Register—not tax benefits in general but those that stem from the ITC (like the mechanism of return of IVA-sales tax in the purchase of goods and services in the country with resources of the ITC; or the regime of

privileges for official visas for representatives of ENIEX, for foreign entities)—they are not obligated to register; **unless the ITC is “official” (of the State) or should be channeled through the State (as is the case of the ITC of certain bilateral or multilateral organisms), in which case it should register.**

- c. In regard to the constitutional right of privacy, we would like to mention the “constitutional principle of publicity” and the “constitutional principle of transparency.”

Traditionally it was argued, including in this lawsuit, that the principles of publicity and transparency only referred to the Public Administrative Entities (governmental institutions or organizations), not in general to private entities.

Nevertheless the Constitutional Tribunal considered that although these principles should be applied, in the first place, to government officials “(...) *it cannot nor should not be ignored its reach and normative significance in the ambit of the civil society*” (Fundament 50); consequently, it applies to private organizations linked to topics of public interest. Therefore, the collectivity and the society as a whole have a stake in the adequate management of the activities of these types of entities.

However, the Constitutional Tribunal interpreted that the principle should be balanced, considering that: (i) the guarantee of the transparency principle cannot be presented only as punishment, but as means of preventive social control, and (ii) these principles should be interpreted in the case of private entities with the presumption that their affairs have a private nature, inasmuch as nobody is obligated to do what the Law does not order or avoid doing what the law does not prohibit (Article 2, subsection 24 of the Constitution), valuing in each circumstance the committed public interest.

4.3.3. Execution of the expense and nature of the resources of the ITC.

- a. A very important topic discussed is the nature of the resources of the ITC, the purpose and the supervision of the Public Administration in relation to the use of such resources, and the disposition about “prioritizing” non-reimbursable International Cooperation and informing about the execution of the expense.
- b. On this matter, the sentence of the Constitutional Tribunal makes clear that the “prioritizing” of ITC resources should be established only when the resources are from the ITC negotiated by the State. When the resources were negotiated from the private sector (as are the cooperation agreements or donations from the cooperating sources, which are private agreements), this faculty of the Administration will have only an indicative character (Fundament 84).
- c. In relation to the specific topic related to informing about the execution of the expenses, the Tribunal declared unconstitutional this part of the norm, indicating that “each one of the NGOs included in the ambit of the norm (and with greater reason those that are not) are the ones in charge to verify the adequate execution of their resources for the best obtainment of their social and welfare aims, according to the prioritizing that can be established; in consonance with the contractual terms of the private agreements of the donations celebrated with their cooperating sources” (Fundament 64).
- d. That is to say, the private character of NGOs’ agreements with their cooperating sources for the execution of projects was rescued. In fact, they contain several clauses with obligations of the executing entity on the application of the resources, special bank

accounts, and render of accounts, in order to guarantee by contract the application of such resources to the goals indicated in the agreement.

The State does not have a situation of disposition in relation to such resources (they do not intervene or manage through State administrations), but the Constitutional Tribunal recognizes a “duty of guarantee and protection” by a means of rules oriented to its control, supervision, inspection, transparency, and publicity.

Therefore, in the assumptions that the Law requires to raise this “natural reserve” or privacy of the information (private legal relations) of the NGOs, this can be accomplished for the fulfillment of some public function; for example, it is especially established in the legislation in the cases of investigation of a crime (criminal law) or the lifting of tax reserve in the cases specially established.

5. FINAL REMARKS

In conclusion, we can affirm that the most important legal topic that Civil Society Organizations have confronted, specifically the NGOs in Perú, is the one derived from the supervision and control by the State in relation to the resources coming from non-reimbursable International Technical Cooperation (ITC) that are channeled and/or carry out through such entities, whether nationals or foreigners.

In this sense, an important pronouncement of the Constitutional Tribunal of Perú exists (Ruling of the year 2007 because of an action of unconstitutionality), which, even though it didn't annul all of the articles questioned of the law modifying the law of creation and functions of the APCI, definitely constitutes a valuable tool of analysis and interpretation in relation to the role of the State in the supervision of these entities, which we consider a valuable precedent inclusively for the region of Latin America. Therefore, this important pronouncement should be taken into consideration in each specific case of supervision and control of the State, in relation to NGOs that channel and/or carry out International Technical Cooperation, as well as in relation to new attempts in the case of Perú or tendencies in our region of new laws or modification of the existing norms designed to supervise the resources of International Technical Cooperation and, finally, the functioning of these types of entities, considering that fundamental rights such as freedom of association, privacy, freedom of contracting are involved.

On the other hand, a flexible and open framework, as in the case of Perú, at the level of the regulation of civil associations (the legal type more used in the ambit of CSOs and, in particular, NGOs), usually is suitable in order to promote or, in another way, not to limit the performance of these type of organizations. However this benefit can, in an adverse political context, turn into its own threat, especially if the topic related to render of accounts is not generalized and interiorized at the level of CSOs (accountability) and/or it is perceived as such.

So this takes us to the initial question of: ***How to obtain an “adequate” balance between transparency of the CSOs and supervision of the State?*** This answer, more than legal, is linked to the definition of the role of the State in respect to Civil Society Organizations as a whole, which translates into an answer of political content, the legal framework as instrument or means of expression of said policy. In this sense, in the case of Perú, the ruling of the Constitutional Tribunal, dated August 29, 2007, constitutes a valuable tool of analysis, not only legal, but also social-political towards the search for the proper “balance between public and private,” “between freedom and authority,” within the democratic concept of a Social and Democratic State.

Thus, concerning the legal framework, beyond the interests of a certain government, it is necessary to establish clearly the “habilitating causes” and motives that justify – in an objective way without violating fundamental rights – the supervision by the State of NGOs and CSOs activities in general.

But, on the other hand, CSOs as a whole should establish self-regulation mechanisms that contribute to a wider transparency and visibility in their performance; which will definitely contribute to strengthen their continuity and institutionality.

Bibliography

Belaunde, Javier and Parodi, Beatriz: “Legislación vigente para el sector privado y sin fines de lucro en el Perú,” en Oliveira, Anna Cynthia (compiladora), en: “Marco regulador de las organizaciones de la sociedad civil en Sudamérica,” International Center for Not-for-Profit Law, Esquel Group Foundation, BID y PNUD, 1997.

Belaunde, Javier and Parodi, Beatriz: “Marco legal del sector privado sin fines de lucro en el Perú,” en “Apuntes 43,” segundo semestre 1998, Lima: CIUP, 1998.

Méndez, José Luis (Coordinator), “Organizaciones civiles y Políticas Públicas en México y CentroAmérica,” México: ISTR-Academia Mexicana de Investigación de Políticas Públicas A.C., 1998.

Portocarrero, Felipe; Cynthia Sanborn; Hanny Cueva and Armando Millán, “Más allá del individualismo: el tercer sector en el Perú,” Lima: CIUP, The Johns Hopkins University, 2002

Article

Endowment Funds: New Developments in the World of Philanthropy in France

Philippe-Henri Dutheil¹

The endowment fund is the latest addition to the family of foundations. It is a tool designed as a vehicle for patronage activities initiated by both individuals and legal entities (businesses, professional organizations, etc.), and has a number of innovative characteristics.

Groundbreaking – revolutionary – shock to the system: Article 140 of the French Act for the Modernization of the Economy of 4 August 2008 has been described in the strongest possible terms.

Indeed, this text gave rise to the endowment fund, a new non-profit-making organization (NPMO) defined as “*a non-profit-making legal entity under private law that receives and manages, through capitalization, assets and rights of any kind that are contributed to it free of charge and irrevocably, and uses the income from the capitalization in order to carry out work or a mission of general interest, or redistributes this income to assist a non-profit-making legal entity in the performance of its work and missions of general interest.*”

According to the Ministry of the Economy, Finance and Industry, which initiated this innovation, the endowment fund was designed to have:

- the simplicity of associations;
- the tax and legal advantages of foundations (*fondations reconnues d'utilité publique*).

What exactly is an endowment fund? How should we assess this new tool?

The endowment fund, the next generation of foundation

An endowment fund is legally akin to the foundation “family,” since they are defined as being an irrevocable assignment of rights or assets to a cause of general interest. However, endowment funds also take on characteristics of other types of NFPOs (non-for-profit organizations).

The flexibility of the “association” status...

The use of the terms “*non-profit-making legal entity under private law*” to define an endowment fund naturally refers to the definition of an “association,” an agreement under which persons form a group with a goal other than sharing profits.

Moreover, when we compare the very strong constraints that exist for the setting-up and operation of foundations with the simplicity offered to NFPOs, it must be observed that the endowment fund presents some points in common with the legal form of the NFPO.

¹ Philippe-Henri Dutheil is chairman of the International Not-for-Profit Organizations Network for Ernst & Young and a member of ICNL’s Advisory Council.

Indeed, the rules for setting up and operating an endowment fund are as unrestrictive as those applicable to NFPOs. In this respect, we should mention:

- legal formalities for formation reduced to a bare minimum: it is sufficient to merely file the articles of NFPO at the Prefecture, followed by publication in the Official Journal;
- flexible management conditions: any endowment fund must be managed by a Board of Directors. The only rule laid down is that this Board must have at least three members. Therefore, there is considerable freedom in the governance that may be implemented.

No prior administrative authorization is necessary, nor is compliance with the complex governance rules such as they exist for most types of foundation.

We should also note the virtual absence of fundamental, mandatory rules for this new type of NFPO.

Apart from the characteristics arising from the definition used in Article 140, a number of options are open:

- Setting-up by one or more individuals or legal entities, be they public or private, French or foreign, regardless of their kind or activities;
- Setting-up for a definite or indefinite period;
- The possibility of opting for an endowment (the “capital” of the fund, which generates income), either intangible or consumable, with no minimum amount being stipulated for this endowment.

... combined with the tax and legal advantages of foundations.

The lawmaker has provided the endowment fund with attractive legal characteristics, comparable to those enjoyed by the most complete forms of foundation:

- **Broad capacity to receive donations:** An endowment fund may receive all types of gifts: hand-to-hand donations, donations and bequests, own resources, financial income, etc. Moreover, the right to object conferred upon the Prefect by Article 910 of the French Civil Code is not applicable to endowment funds: they may freely receive the gifts made to them (donations, bequests). However, there is one important exception: collecting public subsidies is prohibited (except in cases of a joint order by the ministries responsible for the economy and the budget - Art. 140, §III);
- **Unlimited capacity to hold assets of all kinds;**
- **Varied resources:** an endowment fund may not just receive gifts, including those arising from an appeal to the public, but may also collect the income generated by its endowment (rents, dividends, etc.) as well as own income from its commercial or economic activities (sale of assets, payments for services rendered).

Like foundations (and associations), endowment funds may be exempted from trade taxes (VAT, CIT at the regular rate, business tax) if they comply with the conditions set forth for any NFPO (management with no financial interest, absence of privileged ties with businesses in the market sector, activities that are non-competitive or that are carried out under different conditions than those developed by profit-making structures).

A specific tax guideline has been announced. It should notably specify the principles that will apply in the event of the coexistence of profit-making and non-profit-making activities.

An endowment fund may also benefit from:

- exemption from the tax on their capital income (on the condition that the endowment of the endowment fund not be consumable);
- exemption from all free transfer taxes concerning gifts and bequests made to them.

With respect to the tax incentives for patronage, it should be emphasized that the endowment fund has been placed within the scope of application of Articles 200 and 238 *bis* of the French Tax Code (FTC): subject to compliance with the usual conditions in this respect, donors may benefit from an income tax credit of up to 66% of the amount of the gift (individual patrons) or a corporate income tax credit of 60% of the amount of the gift (legal entity patrons).

On the other hand, as the laws currently stand, an endowment fund may not benefit from the reduction in the *Impôt de Solidarité sur la Fortune* (wealth tax) that falls within the scope of Article 885-0 V *Bis* A of the FTC. This is the main remaining comparative advantage in favor of structures such as the common public interest, university or partnership foundations.

How should we assess the endowment fund?

A minimal required framework...

Certain aspects of the operation of an endowment fund were specified in Decree no. 2009-158 of 11 February 2009.

This text, which supplements the legislative provisions, sets out different obligations and requirements that must henceforth be respected by any endowment fund.

The law already stipulated that a Statutory Auditor must be appointed for any endowment fund whose annual resources exceed EUR10,000, a relatively low threshold which will likely be reached by many funds. Further, the Decree then specified the conditions for the Statutory Auditors' work for the endowment fund.

The powers granted to the departmental Prefects are also specified, at the heart of the endowment fund control mechanism. The formalities for setting up an endowment fund must be fulfilled with this administrative authority.

A highly detailed activity report must be sent to the departmental Prefect every year, including:

- an activity report: internal functioning and relationships with third parties;
- the list of funded actions of general interest, together with the amounts;
- the list of beneficiary legal entities, together with the amounts;
- if an appeal to the public has taken place, a report on the use of the resources;
- the list of gifts received.

The Decree also lists the various serious problems that affect the carrying-out of the purpose of the endowment fund (breach of the financial management rules, consumption of the capital endowment, failure by the statutory auditor to comply with the audit rules). If the public

administration observes any of these problems, he/she may suspend the fund's activities, or even instigate a dissolution procedure.

The Decree also specified the conditions of financial management for endowment funds. Each Board of Directors is competent to define the fund's investment policy. The articles of association must specify the rules applicable to this investment policy and notably include the rules of dispersion by investment category as well as a limitation by issuer. The only authorized investments are those mentioned in Art. R 931-10-21 of the French Social Security Code, i.e., those authorized for Provident Institutions. If the endowment exceeds EUR1 million, a financial consulting committee must be set up.

Lastly, we note that endowment funds may only appeal to the public with prior authorization from the authorities, whereas a simple information notice is sufficient for an appeal to the public made by an association or a foundation. The public administration, to which the endowment fund must refer an appeal for donations, may refuse such fundraising campaigns for various reasons relating to the cause the fund intends to support, the prior criminal convictions of its directors, etc. After two months, no response from the authorities is deemed as tacit acceptance.

In practice, these operating rules are not very restrictive for most endowment funds, which are concerned by compliance with the laws.

... which reinforces the attractiveness of an endowment fund

The characteristics of an endowment fund make it a particularly attractive tool for bearers of general interest projects, be they individuals or companies.

The absence of legal restrictions before set-up and in terms of governance, as well as the substantial existing tax incentives, will surely allow endowment funds to fulfill the role assigned to them. Let us recollect that Article 140 of the Act for the Modernization of the Economy falls within a section entitled "*Attracting private funding for general-interest operations.*" Without wanting to anticipate the change in mentalities that this objective implies, given France's traditions with respect to philanthropy, the proposed legal vehicle seems perfectly adapted.

Project bearers will notably be able to maintain control over the endowment fund set up, which is a significant change in philosophy with respect to existing foundations so far, in which the governance required by the laws and the authorities have the effect of mitigating the power of the founders.

This trend is in sync with the changes observed in the attitude of most patrons and philanthropists. While in the past the act of giving was considered to be sufficient in itself, current donors are taking an increasing interest in how their donation is being used, even wishing to structure its use themselves. The fact that a donor wishes to sit on the Board of Directors of an association or foundation that he/she supports is no longer unusual.

Similarly, the decrease in administrative authority over the bodies that bear actions of general interest corresponds to a strong trend in recent years. Patrons, who are often business managers, are finding it more and more difficult to have to submit to a sometimes-punctilious administrative control (cf. procedures to set up common public interest foundations or corporate foundations). Further, the administrative procedure to be respected gifts or bequests granted between private individuals remains an issue, even if it has recently been made less burdensome. In this respect as well, the endowment fund is in step with modern times.

Therefore, no one doubts that the endowment fund will enjoy a well-deserved success in coming years.

However, a string of abuses would suffice to discredit the endowment fund. Let us recollect the damage done in the past by scandals such as that at the *Association pour la Recherche sur le Cancer* (Cancer Research Association) in the 1990s. This could lead the authorities to further regulate this legal form, or convince donors to move away from this type of structure.

Genuine vigilance will be necessary, both on the part of the founders and managers of endowment funds and of their Boards, precisely due to the significant latitude granted to them.

In particular, serious consideration must be given to the governance implemented when setting up future endowment funds, in order to avoid situations in which bad management, grave errors of judgment or even embezzlement may not be detected early enough.

Article

Legal Framework for External Supervision of NGOs in Current Czech Law

Katerina Ronovska¹

Supervision of NGOs is a very sensitive issue that has become the focus of frequent debates. The term “supervision” can have different kinds of meaning. Supervision can be internal or external, private or public, governmental or nongovernmental, prior (and also preventive) with regards to establishment, or subsequent, judicial, etc.

The reason for the necessity of some form of supervision is, above all, the effort to achieve public accountability, legal security, certainty, and protection of third-party rights, assets, and the will of the founders, as well as to enforce compliance with the law and to correct any wrongdoings. If supervision functions properly, it contributes to the maintenance of legal certainty and can act as a motivating factor. However, if it is inadequate, it may have quite the contrary effect.

This article provides a summary overview and constructive critique of the concept and practice of external supervision of NGOs in the Czech Republic, as provided for by current Czech law.

I. External supervision with regard to the establishment and operation of non-profit organizations

1. Governmental supervision (general)

It is a political decision whether the creation of an association as a legal person depends on its recognition by the state, a signature of a notary public, its incorporation in the relevant registry, or merely the agreement of its members.

The current legal regulation of association law² gives the registering authority to the *Ministry of the Interior*, i.e., a body of state administration.³

It is clear that a greater freedom is assured when the government does not interfere with the formation of associations as legal persons. On the other hand, it is in the interests of members and third parties that the content of the fundamental document is in harmony with the law. The assessment of the acceptability of the purpose of an association is carried out at the very moment of its creation, which depends on its registration (i.e., the acknowledgment by the public authority). However, such a prevention-oriented check is not very effective since it may happen

¹ Katerina Ronovska works as an assistant professor of civil law at Faculty of Law, the Masaryk University of Brno, the Czech Republic, email: katerina.ronovska@law.muni.cz.

² Act no. 83/1990 Coll., on association of Citizen (Civic Associations), as subsequently amended.

³ If state administration is active in the process of the creation of associations, it should play the role of a protector of the law only. It should not, for instance, evaluate the aims of associations from the political perspective. It is obviously necessary to act when a legal person acts in conflict with the public order but legal personality should not depend on the subjective view of some body of the state administration.

that the founders do not reveal their actual purpose. There is the danger of unjustified refusal to register an association.

In spite of these arguments, I do not believe it is the most suitable solution if the competence related to the exercise of the right to the freedom of association is, in a democratic state, given over to a state administration body, namely the Ministry of the Interior, which cannot be even formally considered as independent or apolitical. In comparison with the legal regulations in other countries, and especially the more developed West European democracies, it may be concluded that the current conception does not correspond to European best practice.

The new Civil Code aims to change the existing legal regulation of the creation of associations. Under the proposed regulation,⁴ the registration principle had to be abandoned and replaced by a form more conforming to the constitution—i.e., the principle of freedom of creation and the subsequent record of the association with the relevant authority, made on the basis of a notification.

However, the Ministry of the Interior strongly objected to this conception during the comments stage. Despite the argumentation of the drafters of the new Civil Code, the registration principle found its way back into the final version of the draft. At the same time, it was definitely decided that associations should be removed from the scope of powers of the Ministry of the Interior. Instead, they should be subject to a registering body common for all kinds of legal persons. This might be a registry court or a registering body established by the Ministry of Justice.

The NGO sector keeps on trying to change this political decision, mainly through the Government Council for NGOs. A suitable compromise could be found in the application of the “evidentiary” principle, under which associations would be formed not upon registration but already upon the delivery of the motion to register an association to the registry of the relevant authority. This principle would conform better to constitutional and international law. Moreover, it would not be new to the current Czech legal situation: it is already applied in the process of the formation of trade union organizations and employer organizations.

There are many reasons for associations being registered in a *public registry*. However, the Czech *Registry of Civic Associations* is not a public list, which is unsatisfactory mainly due to the protection of third-party rights. This drawback should be addressed in the new Civil Code by the establishment of a public registry of associations.

Society has an interest in preserving the property of *foundations and endowment funds* for the performance of the foundation purpose due to the protection of third-party rights (founders, donors, beneficiaries, creditors, etc.), whereby foundation freedom is being lawfully limited.

One of the reasons for the existence of *external supervision* over foundation subjects is the fact that they are defined as existing without any body (similar to the general assembly of members of corporations) that might give rise to a foundation’s will, balance out the position of the executive body, and have a certain supervision over it. It is true that individual foundation

⁴ Section 151a of the proposed draft of the general part of the Civil Code, *Eliáš, K*, available at www.justice.cz, cited on 15. 10. 2006.

subjects are typically established with *internal supervision* bodies (supervisory boards); however, these cannot replace the role of the supreme body.

If the external supervision functions properly, it contributes to the maintenance of legal certainty and motivates potential founders of foundations. However, if it is inadequate, it may have quite the contrary effect.

There are no special external supervisory bodies for foundations in the Czech Republic, although they were originally included in the governmental draft of the Act on Foundations and Endowment Funds. However, during the discussions of the draft in the Parliament, this section was found to be redundant and too expensive and, as a result, removed. Despite this fact, the current law⁵ provides for a number of preventive measures reducing the possibility of misusing the institute of the foundation.

External supervision over foundation subjects is performed by courts administering the foundations registry and the relevant tax administrators (internal revenue offices). There is, of course, the possibility of not only civil but also criminal court proceedings.

Since emphasis is placed mainly on the *prevention* of possible mistakes, Chapter VI of the Act on Foundations and Endowment Funds provides relatively strict rules for bookkeeping and the preparation and publication of annual reports, as well as the possibility of compulsory audits. The preventive character is further evidenced by the duty to draft the deed of establishment (foundation charter) in the form of a notarial deed. Public access to annual reports is compulsory, whereby the “transparency” of the economic situation of foundation subjects is assured.

What was stated above concerning foundation subjects applies correspondingly to *public benefit institutions*.⁶ There is likewise an absence of a special supervisory body, while emphasis is placed on prevention combined with control by courts and tax administrators.

However, the founder of a public benefit institution has a highly specific position. This is manifested in the actual establishment of the institution because the founder may specify that the deed of establishment determine that a certain number of members of the governing board or the supervisory board shall be elected or appointed upon the motion of a specific circle of citizens, a specific legal entity, local self-government body, or a body of the national government (e.g., the local community may influence the management staffing of a school, retirement home or cultural institution of which it is a founder). In this way, a certain influence is exerted over the “internal life” of a given subject.

2. Court supervision

Under the valid law, an association may be forcibly cancelled only on the basis of a final and conclusive administrative decision by the Ministry of the Interior, with reference to an explicit list of reasons delimited by law. Such a decision, however, has to be preceded by a compulsory notice and a request asking the association to refrain from such activities. A remedy against the cancellation of a petition may be filed with the court.

⁵ Act no. 227/1997 Coll., on Foundations and Endowment funds, as subsequently amended.

⁶ Regulated under Act no. 248/1995 Coll., on Public benefit institutions, as subsequently amended.

I believe that only the court, as an independent body, and not Ministry of the Interior, should have the power to terminate any association undertaking unlawful activities or acting in conflict with its articles of association. In fact, it is a status-related issue the decision of which should be exclusively taken by court. However, this is currently not possible under the valid Czech law, which I consider to be highly inappropriate.

The current law does not provide for any direct public law supervision over foundations and endowment funds. The supervision by the state is performed indirectly mainly by the relevant courts which always act on the basis of a motion submitted to them (by the founder, the executor of a testament, the governing board, or some other person evidencing a legal interest). In exceptional cases, it may decide even without being submitted a motion.

A decisive role in the *creation* (registration) of a foundation entity is played by the decision of the registry court. A proposal to register the foundation/endowment fund in the registry is submitted by the founder or the executor of the testament or a person authorized by these in writing; the proposal must be accompanied by its foundation charter and other documents.⁷

A foundation/endowment fund can be *wound up* by the court decision on winding up or by the declaration of bankruptcy or the rejection of a bankruptcy motion due to insufficient assets. The court will wind up a foundation whose foundation equity (endowment) yields no revenues on a permanent basis and the foundation has no other assets and thus cannot fulfill the purpose for which it was set up or whose foundation equity falls under CZK 500,000 and the foundation fails to rectify the situation within a specified period of time. The court can wind up an endowment fund whose assets have been irrevocably used up (disbursed) and the endowment fund can no longer fulfill the purpose for which it was set up.

The court can also wind up a foundation/endowment fund if the foundation subject in its activities gravely or repeatedly violates the Act on Foundations, its foundation charter or statute; if in the last year, not a single session of the governing board was held or no members of the bodies were elected, nor a controller, to replace those members whose membership or office ceased to exist more than one year ago; or if the foundation endowment fund did not fulfill, in the period of at least two years, its purpose for which it was set, and the foundation subject fund did not make efforts to rectify the matter by the deadline extended by the court.

The winding-up is also possible when the governing board fails to appoint the liquidating officer. In such a case, an officer shall be appointed without unreasonable delay by the competent court.

If the foundation/endowment fund lacks a statutory body or just the board of directors is left with a single member due to the cessation of membership in the governing board of directors, new members of the board of directors will be appointed by the court upon the nomination by the Founder, the executor of the testament, the supervisory board, or even without any such nomination.

The court likewise decides on the possible change of the foundation purpose since this right is not vested in any internal body. In general, it is required that this purpose be changed as

⁷ Section 5 subsection 3 of the Act on Foundations and Endowment funds.

little as possible (this is the *doctrine of cy-prés*).⁸ The Czech legal situation does not deal with the issue of a change of purpose. No body or subject is named to decide on such a change, which is unsatisfactory. As a result, it is adduced that, although the law fails to provide this explicitly, such a change is to be decided upon by a court.

The cessation of a foundation's existence is also conditioned by a constitutive decision by the registry court—i.e., the deletion from the registry of foundations.

What was stated above concerning the creation and termination of foundations and endowment funds applies correspondingly to public benefit institutions.

The court can, acting upon the motion of a governmental agency, the founder, or a person evidencing some lawful interest, decide on the winding up of the public benefit institution and on its liquidation if:

- a) no meeting of the governing board took place in the last year;
- b) no bodies (organs) were appointed and the term of office of the lastly appointed bodies of the organization had expired over a year ago;
- c) the organization has failed to render the publicly beneficial services specified in its deed of establishment for over six months;
- d) the quality, scope and availability of the publicly beneficial services for the rendering of which the public benefit institution was founded has been repeatedly endangered over the last six months;
- e) the organization uses the income from its operations and the assets it manages or acts otherwise in conflict with the law.

The court may set a period of time for remedying the cause for which the motion for winding up the public benefit institution was filed.

When the governing board fails to appoint the liquidating officer, such an officer shall be appointed without unreasonable delay by the competent court.

3. Supervision by tax authorities

Associations, foundations, endowment funds and public benefit institutions are obliged to make available their financial records and other administration to the tax authorities. The tax authorities do not supervise the organizations as such; they only check that they pay the right amount of tax, are legitimately exempt from certain taxes, or enjoy some special treatment.

Public benefit institutions also enjoy a special legal regulation. If the organization defaults in its duties under the law (Sections 2, 17, and 20), it shall be stripped of the tax benefits set forth by the Act on Public Benefit Institutions, by the Income Tax Act,⁹ and by the Inheritance, Gift and Property Transfer Taxes Act¹⁰ for the year in which such violation occurs,

⁸ The term originates in the French phrase “*aussi prés*,” meaning “as close as possible.” See also Riemer, H. M.: *Berner Kommentar, Personenrecht, Die juristische Personen*, 3. Teilband, *Die Stiftungen*, Systematischer Teil und Kommentar zu Art. 80 – 89bis ZGB [Commentar to Swiss CC], Verlag Staempfli, Bern, 1975, p. 238 a f.

⁹ The Act No. 586/1992 Coll., on Income Tax, as subsequently amended.

¹⁰ The Act of the Czech National Council No. 357/1992 Coll., on Inheritance, Gift and Property Transfer Taxes, as subsequently amended.

and also of the tax benefits set forth under the Property Tax Act¹¹ for the next tax period following that in which the violation occurs.

II. Supervision with regard to other matters (e.g., enforcement of fiduciary duties and solicitation law)

Other persons participate in the supervision, e.g., the founder, the executor of a testament, and other persons evidencing a lawful interest. They may, in situations specified by the law, file a motion for the winding up of a given legal person by court. This, however, is not possible in the case of associations: these may be cancelled only by the Ministry of the Interior.

The enforcement of fiduciary duties in associations is merely a matter for the general meeting of members, which can dismiss the members of the governing board when they do not fulfill their fiduciary duties.

The enforcement of fiduciary duties of the members of the governing board of a foundation (endowment fund) may be the task of the supervisory board. However, as noted above, certain powers are also held by the relevant court.

The Act on Public Benefit Institutions contains a special regulation as regards subsidies from public budgets (state, regional, or municipal budgets) and state funds. The subsidies—from the budget of the central government, the communal budget, the district administration office budget, or the budget of some other territorial body of public administration—may only be granted to the public benefit institution for one and the same project or one and the same activity from a single source. The organization can apply for a subsidy from the governmental budget to the competent governmental body according to its prevailing activity. The body through which the subsidy is being granted shall decree the terms and conditions for granting the subsidy and it shall inspect and evaluate the utilization of the subsidy provided.

There are no similar provisions for associations and foundations (endowment funds). Certain rules, however, are provided by public law regulations—the most important being the Act on Municipalities, the Act on Regional Units, the Act on Budgetary Rules, the Act on Budgetary Rules of Regional Budgets, and the Act on the Property of the Czech Republic and its Representation in Legal Relations.

It is also possible for contracting parties to agree on other rights and obligations in their agreements on the provision of financial means, regardless of whether this concerns money from public or private sources. Any violation of such rules may be sanctioned by, e.g., the duty to return the contribution made.

III. Conclusions

State intervention in the internal matters of associations should generally be precluded by the constitutional right to the freedom of association. However, there is usually a legitimate attempt to establish certain norms limiting such a freedom, mainly due to the necessity to protect public order and third-party rights. A certain balance between the necessary control and the actual freedom of association should be observed. The law currently valid in the Czech Republic is not satisfactory from this point of view. It is wrong, in my opinion, to delegate the administration of associations to the Ministry of the Interior. Although law on civic associations

¹¹ The Act No. 338/1992 Coll., on Property Tax.

quite unambiguously regulates the process of establishing an association as well as the objective conditions which may lead to the registration's refusal, the approach exercised by the Ministry causes a number of problems.

In several cases,¹² the Supreme Administrative Court ruled that any attempts taken by the Ministry to judge the registration or statutes proposal subjectively are unacceptable, similar to laying any obstacles or conditions other than those prescribed by law. Based on the aforementioned decision-making practice, one may observe a clearly marked tendency to remove any doubts concerning the lawfulness of the approach taken by the Ministry within the registration proceedings. In fact the Ministry's practice has evolved in such a way that the proceedings of the registration authority have, in fact, become approval proceedings,¹³ which is in sharp contradiction not only to the Czech constitutional laws but also to the right to freedom of association stipulated by international documents. In addition, the legal regulation of the internal relations of associations, mainly for the protection of members' rights and third party rights, is likewise insufficient.

As regards the supervision over foundations, endowment funds, and public benefit institutions, I believe that a policy emphasizing prevention combined with judicial control is desirable. This appears to be more suitable than the establishment of special authorities to oversee the activities of such subjects. In comparison with administrative (public) control, the judicial control has many advantages.

A significant role is also played by public supervision, i.e., not state supervision. This is carried out through the participation of other persons, e.g., the founder, the executor of a testament, and other persons evidencing a lawful interest. Last but not least, the obligation to publish annual reports and closing accounts contributes to the transparency of these subjects.

To conclude, the external supervision should be a supplement to internal supervision, and should be always exercised only in an objective way and limited to check lawfulness of the purpose and activities of NGOs.

The combination of well-functioning internal supervision, private external supervision, and the supervision by the court are, due to the rigorous and extensive character of the legal provisions concerning the foundation law, in my opinion, sufficient. There is no need for some special supervisory organ to be established by the state.

On the other hand, there are some countries, e.g., Switzerland, which do have such a state supervisory body for foundations and find it very useful. The same holds for the Charity Commission in Great Britain. Those bodies not only control but often give advice and consultation to the NGOs.

A highly topical issue is the necessity of supervision over NGOs by the state in order to prevent the misuse of NGOs for the support of worldwide terrorism. This issue, however, is beyond the scope of the present article.

¹² Decisions of Czech Highest Administrative Court sp. zn. 7 A 13/2002-46, sp. zn.1 Ans 8/2005-165 and 1 Ans 3/2007- 235

¹³ blíže k tématu registrace občanských sdružení např. www.net.aid.cz, citováno 14. 10. 2008

Article

British Charities and Insolvency

Pesh Framjee¹

Summary of key points

- There are normally two tests of insolvency—the balance sheet test (positive net assets) and the cash flow test.
- The key issue is, can the charity pay its debts as they fall due?
- Careful consideration is required of many factors such as what values can be realized in time to meet debts and what assets can be used to meet liabilities.
- Understanding is needed of the implications of the different restricted and endowed funds held by the charity.
- The position for trustees of an unincorporated charity is different and the risks are usually higher.
- Directors and shadow directors can be guilty of wrongful trading if they continue to trade and incur liabilities after they knew or ought to have known that there was no reasonable prospect of avoiding insolvent liquidation.
- Fraudulent trading is also a risk.
- The charity should avoid entering into preferential transactions which put another party in a better position to the detriment of other creditors.
- The court will recognize mitigating circumstances—for example, if the directors took proper steps to minimize the potential loss to the company's creditors.
- The Companies Act requires that the accounts are prepared on a going-concern basis unless there is a reason to believe that this is not appropriate. Therefore, Directors must consider whether the entity is a “Going Concern.”
- “Cash is king.” Charities should ensure that they focus on careful cash management.
- Good management information is vital and it is important to reassess how the charity identifies what matters, recording and reporting on what matters.
- Knee-jerk reactions are risky and careful consideration of reserves and how they can be used coupled with cost optimization and a real focus on income can help

¹ Pesh Framjee is the Head of the Unit providing services to Not For Profit Organisations at Horwath Clark Whitehill LLP. He is also Special Adviser to the Charity Finance Directors' Group and joint author of “Managing your solvency,” published by the Directory of Social Change (1994). Framjee is a member of the Charity SORP Committee and the Accounting Standard Boards Committee on Accounting for Public Benefit Entities.

manage the situation.

- It is important to look beyond the obvious and to recognize that the impact on income generation may be delayed but reduction in income can be sudden with little warning and therefore good communication and careful evaluation and forecasting are needed.
- There should be action plans for different scenarios and monitoring of trigger points and trend analyses to enable the charity to decide when it needs to put the plans into place.
- All decisions must be carefully made and the deliberations should be properly recorded.
- The frequency of Board meetings and briefings from management may need to increase and it is vital to show that the Board received proper and up-to-date information to really evaluate the financial position.

Introduction

Difficult market conditions mean that a number of charitable organizations want to understand the rules of insolvency and how this impacts the responsibilities of the Board and management. A number of Finance Directors' Chief Executives and Trustees have asked me about issues such as negative balance sheets arising from pension liabilities and/or falls in investment values or about the possible use of restricted funds and the impact of uncertainties with income generation.

There is clearly concern and a desire to understand the law and regulatory perspective. This article covers many important issues and technical matters so brevity has lost out! It outlines relevant issues but individual circumstances will need to be considered and charities should seek professional advice if they have any concerns about insolvency.

The Insolvency Act 1986 as amended by the Insolvency Act 2000 and the Enterprise Act 2002 (the Act) contains the basic legislation and I have copied relevant sections in the Appendix. The Act applies to charitable companies but in their publication "Managing Financial Difficulties and Insolvency in Charities" (CC12) the Charity Commission states: "*We recommend that, as a matter of good practice, a similar approach is adopted for unincorporated charities.*" (CC12 is available on the Charity Commissions' website, www.charity-commission.gov.uk)

What is insolvency?

It is usually held that a company is insolvent if it is unable to pay its debts.

This view is supported by the Association of Business Recovery Professionals. In their publication "The Ostrich's Guide to Business Survival—Avoiding Financial Failure," they state that: *a company is insolvent if: - it is unable to pay its debts when they fall due: the value of assets is less than the liabilities.*

There are two main tests that can be used to determine the solvency of a charity:

1. The cash flow test: the basis of this test is whether the charity can pay its debts as they fall due. (Section 123 of the Insolvency Act 1986 – see appendix). The test is applied in the following two cases:

- a) where the directors wish to carry out a solvent winding up they would have to state whether the charity will be able to pay its debts in full plus interest within a period not exceeding 12 months from the position of the winding up.
 - b) section 122(1) (f) of the Insolvency Act 1986 provides that the Court may wind up any company that is unable to pay its debts.
2. The balance sheet test: The basis is whether there is an actual or anticipated deficiency of assets over liabilities. A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities. Paragraph 1b) above applies in this case also.

The balance sheet test and its limitations

Due to the application of particular accounting principles and standards, the balance sheet test often does not provide sufficient information about the true position of a charity. For example, tangible fixed assets are usually stated at cost but this may have little relevance to their market value. Also, a pension scheme deficit calculated on the basis of Financial Reporting Standard (FRS) 17 may lead to a negative balance sheet but will not, of itself, impact the cash flows of the sponsoring charity into a defined benefit pension scheme. The cash contributions required by the employer are arrived at through negotiations with trustees and/or through statutory requirements, either of which may involve measuring surpluses or deficits on a different basis from that required by FRS 17. Also, charities follow different income and expenditure recognition policies and this will have an impact on the balance sheet. For example, some charities may recognize as a debtor future grant income whilst others may not and some recognize future grant commitments whilst others do not.

Therefore the cash flow test is seen to be more relevant than the balance sheet test as it attempts to quantify the market worth of assets and when they can be realized and how they can be used.

A balance sheet can be viewed on a going concern basis (see section on Going Concern) or on a breakup basis. On a breakup basis there may be more liabilities that crystallize and the valuation of the assets as well as potential repayments to funders or creditors becomes critical. When financial statements are prepared on a going concern basis, tangible fixed assets such property and equipment are usually represented in the balance sheet at their historic cost less depreciation. This is not usually the value that should be taken into account when considering solvency. The value should be the market value of a forced sale and in the case of a special purpose asset it is highly likely that this value may be substantially below the book value. This is because accounting principles recognize the concept of value to a charity and there is often no need to write down a tangible fixed asset if the value in use is higher than the book.

A charity may face the specter of insolvency even when it has a positive balance sheet. For example, its debtors may be slow in paying, or its assets may be difficult to crystallize or may not be easily available to meet debts as they fall due. Similarly, a balance sheet may appear to show a deficiency of assets over liabilities but the charity may still be solvent if the timing of cash flows means that it can ensure it can meet its liabilities and debts as they fall due.

Totty & Moss, in considering "inability to pay debts," states that: "*It is not clear on what basis the court is supposed to value either a company's assets or its contingent and prospective*

liabilities. It is considered that the value of the assets should be based on estimates of the figures that would be realized in a liquidation; and contingent and prospective liabilities should be valued at the sum for which they would be admissible if a winding-up order was made. The only assets and liabilities to be taken into account are those which flow from contracts entered into and things done by the company up to the time the assessment of ability to pay debts is being made.”

It is also important to consider liabilities not on the balance sheet, such as future commitments and contingencies, which ought to be taken into consideration—for example, any repayments on grants received or costs arising from unfulfilled service contracts. There may also be new liabilities that crystallize on liquidation, such as staff redundancy costs, outstanding lease and dilapidations payments, costs incurred in realizing assets, and professional charges. Charities that operate internationally will have to bear in mind local costs that may crystallize as well as the impact of foreign exchange rates and the ability to repatriate funds or transfer funds from one country to another.

The cash flow test

Prima facie it may appear that this is a simple test—either the charity is paying its debts or it is not. However, the matters to be considered are more complex. S123 (1) (e) provides that a company is deemed unable to pay its debts “*if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.*”

This section was considered for the first time in a recent legal decision relating to Cheyne Finance Plc, one of the early casualties of the “credit crunch.” The analysis is that technical insolvency may be triggered earlier in some cases than might have been expected and that the circumstances may be particularly relevant to charities.

In the decision of *Re Cheyne Finance Plc (in receivership)* [2007], Mr. Justice Briggs considered the level of consideration that should be given to debts falling due in the future and the timing of the cash flows and the ability to use funds to pay certain debts.

In fact the case appears to extend the cashflow test to one where consideration has to be given to not just whether a company is unable to pay its debts but also whether it is likely to become unable to pay its debts.

This then raises the question as to how far forward one has to look. Justice Briggs stated, “*cashflow or commercial insolvency is not to be ascertained by a slavish focus only on debts due as at the relevant date. Such a blinkered review will, in some cases, fail to see that a momentary inability to pay is only the result of a temporary lack of liquidity soon to be remedied, and in other cases fail to see that due to an endemic shortage of working capital a company is on any commercial view insolvent, even though it may continue to pay its debts for the next few days, weeks or even months before an inevitable failure.*”

The court clarified that the availability and use of assets needed to be considered. So a company may have positive net assets but they may not be easily realizable in a way that it could meet its debts.

The judge gave the following example: “*The company has £1,000 ready cash and a very valuable but very illiquid asset worth £250,000 which cannot be sold for two years. It has present debts of £500, but a future debt of £100,000 due in six months. On any commercial view*

the company clearly cannot pay its debts as they fall due, but it is, or would be balance sheet solvent.”

This is particularly relevant for a charity that has restrictions on how it can apply its funds and which funds can be used to meet debts. Therefore the special circumstances of charities and fund accounting need to be considered.

Funds of a charity

The principles of fund accounting require careful consideration in any insolvency situation. In the first place this is relevant when considering the tests described above as it will govern what amounts are available to meet different liabilities. The distinctions between income and capital and unrestricted and restricted funds permeate trust law. Income includes all resources which become available to the charity and which the trustees are legally required to apply in furtherance of the charitable purposes within a reasonable time. This will include the funds held by branches and also restricted income funds. Capital, on the other hand, must be invested or retained.

In addition, due to the constraints of trust law and the important matter of donor-imposed restrictions, many charities receive significant amounts of restricted resources and these restrictions often affect types and levels of services and how funds can be used to meet liabilities. Consequently, information about the nature of net assets and the funds to which they are attributable is vital in assessing a charity's ability to respond to short-term needs or debt payments. Fund accounting requires that the resources of a charity should be grouped according to the restrictions on their use as follows:

Unrestricted funds

These are funds available for general use for any or all of the charity's permitted activities. Unrestricted funds include those that have been designated for particular purposes by the trustees of a charity. They can be undesignated at any time. These funds can be allocated against any potential liabilities of the charity.

Restricted income funds

These are funds that can only be expended in accordance with specific restrictions. These arise either by the wishes of the donor or by the nature of the appeal. These funds are sacrosanct and can only be used for the purposes of the special trust that created the restriction.

It is however possible to seek clearance from the Charity Commission or the original donors (if the donors have reserved the right to alter the terms of the trusts) to vary the terms of the restriction.

Restricted capital funds

These funds are funds that are not for direct application. Where the trustees have no power to apply capital as income, it will be permanent endowment. Where the trustees have a power to expend it if necessary, this will be expendable endowment. An expendable endowment should be treated as capital until the right to expend it is exercised, in which case it should be transferred to income prior to application. Permission can be sought from the charity commission to use endowments in certain circumstances.

Fund accounting is important when considering the use of funds to meet liabilities when the operation is a going concern and there is also the important consideration of who can make a claim on restricted funds in the event of a winding up.

The position of trust funds

A company cannot hold endowed funds as part of its own corporate property as it is implicit that a company is free to spend any or all of its property. A charitable company holds its capital and other restricted funds upon trust because the company cannot apply these funds indiscriminately in furtherance of its statutory objects. However, the liability of the members of the company in relation to its acts as trustee is still limited, and the directors of the company are still acting as the company's agents in relation to the business that the company transacts as trustee.

There is no objection, in principle, to the transfer of permanent endowment to a charitable company, but the company will hold the fund as trustees of the trust for investment that affects it. This is so whether the income of the trust is applicable for the objects of the company generally, or only for some particular purpose within those objects.

The Charity Commission have explained in CC12 that a fund that a company holds on trust is not part of the estate of the company which is available to the general creditors of the company in accordance with the rules of company law—see, for example, *Re Kayford Ltd* (1975).

To access a fund which is held by a company on trust, a particular creditor would have to show the liability was incurred by the company in the capacity of trustee of that fund, and that the company as trustee accordingly had the right to settle the liability out of the fund.

A charitable company can receive gifts in a number of ways. It can receive gifts in augmentation of its corporate property (unrestricted funds). It can receive gifts on trust for its general purposes. It can receive gifts on trust for specific purposes within the objects of the company (restricted income funds). It can receive gifts on trust for investment (endowed funds).

Gifts of the first type are available to a liquidator of the charitable company, even if they take effect after the commencement of the liquidation. Gifts of restricted assets are, apparently, not available to a liquidator of the charitable company. This seems to be just an application of the usual principle that property held by a company on a trust is not available to a liquidator of that company.

There appears to be some confusion in practice about which part of a company's estate is accessible by creditors in accordance with ordinary principles of company law, and which part of the company's estate is only accessible by creditors in accordance with the principles of trust law. Some insolvency practitioners are accustomed to argue that the whole of the property of a charitable company is available for the creditors of a company in accordance with the principles of company law, whether or not it is held on trust. The Charity Commission's view is that generally where the permanent endowment is held on special trusts, this is not the case.

Special trusts are defined in Section 97 of the Charities Act 1993 as "*property which is held and administered by or on behalf of a charity for any special purposes of the charity, and is so held and administered on separate trusts relating only to that property.*" In effect, a special trust is tantamount to a restricted fund.

The Charity Commission's view is that funds which are held by a charitable company on special trust are not available to creditors in an insolvency, unless the creation of the trust can itself be impugned under insolvency law.

Of course, where the charitable company has entered into commitments as trustee of particular funds, creditors will have the usual rights that they have when dealing with a trustee.

The Charity Commission is clear on their position and their views merit careful attention. They state:

"Only liabilities which have been properly incurred in the administration of the particular trust can be met out of the trust property. It could be a breach of the charitable company's duty as trustee to allow assets held on trust to be distributed to its creditors as if those assets were simply a part of the charity's corporate property. Any director, liquidator etc who is responsible for committing the charitable company to such a breach of duty could be in breach of his or her fiduciary duty towards the charity. They could, therefore, be liable to make good a loss of its trust property."

It will, therefore, be important to determine on which basis a gift has been made to a charitable company and there should be clarity as to whether a special trust has been created.

Requirements to set up a trust (restricted funds)

Many charities set up restricted funds in their accounts on the basis of perceived obligations without properly considering whether the funds are legally restricted. In *Knight v Knight (1840)* Lord Langdale MR outlined the three certainties required to create a valid express trust.

1. Certainty of intention

It must be clear that the settlor intended that the property received by the Trustee, to be held in Trust, is a binding obligation and not just a moral wish. The language used by the alleged settlor must be imperative and without ambiguity.

2. Certainty of the subject matter or trust property

The Trust property must be clearly identified, as must the entitlements of the beneficiaries in that property. It must be possible to clearly identify the property that is to be subject to the Trust.

In addition, even if the Trust property is clearly defined, the share or shares in that property to which the beneficiaries are entitled must also be clearly defined.

3. Certainty of objects

The beneficiaries or purposes for which the Trust property is held must be clearly identified.

Liquidation of charities

There are no statutory insolvency proceedings for unincorporated charities and it will fall upon the trustees to carry out the orderly winding up of the charity.

Charitable companies have the benefit of established winding up procedures. A resolution can be passed for a creditors' voluntary liquidation or there can be a compulsory liquidation. The

court will not normally order the compulsory liquidation of a charitable company on the ground of inability to pay debts until after a creditor has either:

- issued a “statutory demand,” and the demand has not been met, or
- obtained a court judgment against the charity, in relation to a claim against it, and that claim has not been satisfied.

In these circumstances the creditor can petition the court to wind up the company. Once a charitable company is being wound up, whether voluntarily or compulsorily, it is placed under the management of an insolvency practitioner as liquidator. It is then too late for the directors to take action of their own to bring the charity out of insolvency.

Usually to preempt an action by the creditors the members can pass a special resolution to put the company into voluntary liquidation. Alternatively, they can pass an extraordinary resolution to the effect that by reason of its liabilities it cannot continue in business and it is advisable to wind it up.

The creditors are paid off in order:

- secured creditors: Secured creditors with a fixed charge over a specific assets can be paid from fixed charge realizations; however, they can only be paid from floating charge realizations after the preferential creditors have been paid in full
- the liquidator’s fees and the expenses of liquidation
- preferential: such as occupational pension scheme payments and certain amounts to employees
- unsecured creditors.

The position of trustees and directors

Trustees of unincorporated charities can be held to be personally liable for properly incurred debts of the charity if the charity has insufficient funds.

A limited company gives an added measure of protection to trustees but should not be seen as a method of removing all liability.

Most charity companies are limited by guarantee. This means there are no shares and instead the members each guarantee to contribute to the company’s debts up to a specified limit. Unfortunately, this sometimes gives a sense of false security.

The liability of the guarantors is the extent they would have to pay in the event of the charity being wound up; it has little to do with the liability of the directors as trustees of the charity. Furthermore, the memorandum of many charitable companies includes a clause that draws aside the corporate veil and limits further the perceived protection of incorporation.

The directors of a limited company can avail themselves of Section 727 of the Companies Act 1985 that offers similar statutory protection to that offered by the Trustees Act. In essence, if it appears to the court that a director is or may be personally liable for any negligence, default, breach of duty, or breach of trust but has acted honestly or reasonably, and ought fairly to be excused for the breach of trust and for omitting to obtain the directions of the court in the matter in which he committed such a breach, the court may relieve the director either wholly or partly from personal liability for the same. It has been held that Section 727 does not apply to the concepts of fraudulent/wrongful trading discussed in the following sections.

Fraudulent trading

Section 213 of the Act provides that on the application of the liquidator of a company, the Court may order that any persons who were knowingly party to carrying on the business of the company with intent to defraud creditors must make a contribution to the company's assets.

For a fraudulent trading action, intent to defraud creditors must be proved and the onus of proof is on the liquidator. There must be evidence of actual dishonesty.

For an insolvent charitable company, senior management, and not just the trustees, could also be made liable for fraudulent trading.

In *R v Grantham (1984)* the judge clarified that an intention to defraud could be inferred if a person incurred a debt, for example by obtaining credit, without knowing that there was good prospect of being able to meet the debt payments as they fell due.

Charity law also requires certain procedures to be followed when mortgages and secured loans are taken.

Wrongful trading

Section 214 of the Act introduced the concept of wrongful trading to protect creditors from the negligence of directors. It covers situations where there has been a failure to exercise proper diligence in managing the company and in taking corrective action when insolvency loomed even though directors may not have acted in bad faith or fraudulently. To establish wrongful trading the Court would need to conclude that at some time before the company went into insolvent liquidation, the directors or shadow directors continued trading although they knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

It is worth noting that the law does not include the words wrongful trading—these words are included in the title to the section. The law itself almost focuses on “irresponsible trading.” The law was designed for situations where the directors ought to be able to recognize that the company is in difficulty and moving towards insolvency and yet do nothing about protecting the interests of creditors.

Preferential transactions

Much of the legislation is designed to protect creditors. Section 239 of the Act deals with the issue of preferential transfers. These are any transaction entered into with a third party that puts them in a better position than they would otherwise have been in—for example, paying off a creditor shortly before the company goes into liquidation, thus ensuring that the creditor receives better settlement than other creditors who would normally have ranked equally. Such transactions can be set aside if they were entered into six months before the onset of insolvency. This period is extended to two years where the creditor is a connected or associated person.

A charity could fall foul of this legislation if it paid grants to beneficiaries or made a transfer to another charity in anticipation of insolvency and other creditors did not get fair settlement.

Similarly, Section 238 deals with undervalue transactions. These are transactions with any party in which the company receives significantly less than the value of that which it has released to the other party. The same time frames apply as for Section 239.

Trustees and directors should resist the temptation to apply funds for “good works” if it could be construed that the application of such funds would be seen as preferential transactions.

Mitigating circumstances

The court will recognize mitigating circumstances—for example, if the directors took proper steps to minimize the potential loss to the company’s creditors. The “knew or ought to have known test” is an objective one. The directors must act reasonably and diligently, bearing in mind both the individual director’s own knowledge, skills, and experience and the general knowledge, skills, and experience that may reasonably be expected of a person carrying out the same functions as the director. A person with relevant professional or legal skills such as an accountant or lawyer would be judged on this basis and thus could be at greater risk.

Standards expected will vary from one case to another. In *Re Produce Marketing Consortium Limited* (1989), the Judge held that the expertise expected of a director is much less extensive in a small company in a modest way of business with simple accounting procedures and equipment than in a large company with sophisticated procedures.

There is also the issue of the level of delegation to management in a charity and the question arises as to what level of care and duty would the courts expect of a non-executive trustee in a wrongful trading case.

Disqualification of directors

After insolvency the Official Receiver or the Insolvency Practitioner is required to send the Secretary of State a report on the conduct of all directors who were in office in the last three years of the company’s trading.

The Secretary of State then considers what action needs to be taken and whether it is in the public interest to seek a disqualification order. An application is then made to the court for a disqualification order. There are a number of reasons why a Director may face disqualification and this could also lead to criminal charges and fines as well as becoming personally liable for company debts.

Examples of conduct that could lead to disqualification include:

- continuing to trade to the detriment of creditors at a time when the charity was insolvent
- failure to keep proper accounting records
- failure to prepare and file accounts or make required returns
- failure to submit tax returns or pay over to the Crown tax or other money due
- failure to cooperate with the Official Receiver or Insolvency Practitioner.

Going Concern

The Companies Act requires that the accounts are prepared on a going concern basis unless there is a reason to believe that this is not appropriate. Directors must consider whether the entity is a Going Concern. This means that there is an underlying assumption that the entity will continue in operational existence for the foreseeable future and that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations.

In addition to company legislation, the issue of Going Concern is covered in Financial Reporting and Auditing Standards. Therefore the matters discussed below are relevant for all charities that prepare accounts that are required to give a true and fair view.

Financial Reporting Standard 18 states:

“21. An entity should prepare its financial statements on a going concern basis, unless:

(a) the entity is being liquidated or has ceased trading, or

(b) the directors either intend to liquidate the entity or to cease trading, or have no realistic alternative but to do so, in which circumstances the entity should prepare its financial statements on a basis other than that of a going concern.

“22. The information provided by financial statements is usually most relevant if prepared on the hypothesis that the entity is to continue in operational existence for the foreseeable future. This hypothesis is commonly referred to as the going concern assumption. Financial statements are usually prepared on the basis that the reporting entity is a going concern because measures based on break-up values tend not to be relevant to users seeking to assess the entity’s cash-generation ability and financial adaptability.

“23. When preparing financial statements, directors should assess whether there are significant doubts about an entity’s ability to continue as a going concern.

“24. If the directors, when making the assessment required by paragraph 23, are aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, paragraph 61 requires them to disclose those uncertainties. In making their assessment, the directors take into account all available information about the foreseeable future.

“25. The degree of consideration necessary to make the assessment required by paragraph 23 depends on the facts in each case. When an entity has a history of profitable operations, which are expected to continue, and ready access to financial resources, detailed analysis may not be necessary.

“In other cases, the directors may, in making their assessment, need to consider a wide range of factors surrounding current and expected profitability, debt repayment schedules and potential sources of replacement financing. Such considerations also govern the length of time in respect of which the assessment should be made.”

I am often asked as to what “foreseeable future” means. Many believe that this is restricted to one year from the date of approving the financial statements but in fact this is usually better considered as a minimum period; if there was a foreseeable event in a later period, it would need to be taken into account. The Auditing Standard on Going Concern explains that:

“It is not possible to specify a minimum length for this period: it is recognized in any case that any such period would be artificial and arbitrary since in reality there is no ‘cut off point’ after which there should be a sudden change in the approach adopted by those charged with governance. The length of the period is likely to depend upon such factors as:

- *the entity’s reporting and budgeting systems*
- *the nature of the entity, including its size or complexity.*

“Where the period considered by those charged with governance has been limited, for example, to a period of less than one year from the date of approval of the financial statements, those charged with governance will have determined whether, in their opinion, the financial statements require any additional disclosure to explain adequately the assumptions that underlie the adoption of the going concern basis.”

The Financial Reporting Council (FRC) published in November 2008 “An update for directors of listed companies: going concern and liquidity risk.” This is available on the FRC website, www.FRC.org. Although this publication is aimed at listed companies it has been written in the context of the credit crunch and contains many relevant issues for charities.

In addition, auditors have to follow specific guidance and even if the going concern basis is appropriate but if there is a material uncertainty, the financial statements must describe the principal events or conditions that give rise to the significant doubt on the entity’s ability to continue in operation and management’s plans to deal with these events or conditions.

Auditing Standards also require that the Directors state clearly that there is a material uncertainty related to events or conditions which may cast significant doubt on the entity’s ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business. This needs to be carefully worded so that it is not seen as a prophecy of doom. In some cases the auditors may draw attention to this in their audit report.

A stitch in time

There is much that a charity can do to avoid a solvency crisis. Charities should ensure that they focus on careful cash management. There are a number of easy wins. For example, many charities continue to have delays in receiving grants simply because they have not completed the paperwork. The message is that “Cash is king” and cash forecasts for income and expenditure become a real must-do.

Good management information is vital and it is important to reassess how the charity identifies what matters and records and reports on what matters. Knee-jerk reactions are risky and careful consideration of reserves and how they can be used coupled with cost optimization and a real focus on income (see pages 30-32 in *Caritas* magazine, December 2008) can help manage the situation.

Uncertainty can lead to inaction but the status quo is rarely the best option; however, it is important to avoid knee-jerk and uncoordinated actions. Trustees and management will need to consider many factors and evaluate many possible outcomes and make strategic responses to ensure that the charity is agile, conscious of different factors, and resilient.

It is important to realize that many decisive actions may need to be taken promptly and the charity should ensure it has a decision making process that is nimble and well attuned to gathering relevant knowledge and different perspectives.

Look beyond the obvious and recognize that although the impact on income generation may be some way away, a drop in income can occur suddenly. Therefore, good communication and careful evaluation and forecasting are needed. Focus on the relationship of income with expenditure and the nature of costs. For example, if the organization is one with many fixed costs then it may need to remember it is vulnerable to “super tanker” trends—as income deteriorates it may not be able to reduce costs at the same speed. By the time the “super tanker” has the rocks

in its sights, it can run out of clear water that is needed to change direction in time. The “clear water” for a charity that is trying to react to reducing income may be generated by reserves or by taking early action on costs. Bear in mind the impact of inflation: if income is constant, it has actually reduced in real terms.

There may be a need to focus on core activities and discard the periphery, but beware the trap of cutting activities and expecting that this will result in all their costs being removed. One well-known charity entered into a laudable project of considering which of its activities were providing the best return and then cut out the less “valued” ones, expecting to see a reduction in all related costs. However, many fixed costs that had been allocated to these activities had to now be absorbed by other activities.

The Board and management should have action plans for different scenarios and they should monitor trigger points and trend analyses to enable the charity to decide when it needs to put the plans into place.

Directors and Trustees should ensure that they do not trade when the charity is insolvent, unless they can show that they made a considered decision that there was a realistic prospect that the charity would avoid insolvent liquidation. They should also not take credit or loans that they know they have little prospect of repaying. Similarly, they should not take advances or enter into contracts to deliver goods or services when they believe that there is a low likelihood of delivery.

If the charity is facing a solvency crisis it is important that all decisions are carefully made and properly recorded. There is also need to record the matters that were considered and the extent of the deliberations to ensure that, if it was needed, there is a record that the Board and management were diligent and took the situation seriously.

The frequency of Board meetings and briefings from management may need to increase and it is vital to show that the Board received proper and up-to-date information to really evaluate the financial position.

Finally, it is important to recognize that hard times can offer opportunities as well as challenges. Cost cuts and needed change that may have met opposition in good times are often accepted when there is a downturn. There is also opportunity to renegotiate costs. As others cut back on fundraising and marketing costs it is usually possible to reach more supporters for less expenditure. There are some great deals to be made with desperate media channels. Buyers are able to drive harder bargains with agencies and improve payment terms. For example, at present billboard advertising is almost being given away and agencies are allowing shorter, more flexible contracts.

In conclusion

This article focuses on what happens when things have gone wrong, but prevention is the best medicine. In CC12 the Charity Commission has stated:

“Insolvency can happen overnight, for example where a charity is dependent on grant income which is cut and not replaced by other sources of income. It may also creep up slowly over several years and remain unchecked until the charity can no longer finance its activities.”

“It is essential for a trustee body to have a good knowledge and understanding of the charity and its finances. Although it can be difficult to prevent the overnight collapse, even if it is anticipated, it ought to be possible to prevent or delay the onset of creeping insolvency.”

“The action necessary can be summed up as being ‘effective management and control.’ The responsibility for creating this environment rests with the trustees, but will involve all staff members whether paid or volunteers.”

The task of setting priorities for charities will be even more difficult than ever, matching the increasing demands to satisfy short-term needs against pressure for the resources required to achieve long-term solutions. The charity sector is going through, and will continue to face, a period of real challenge and change. Necessary change must not be brought about at the expense of motivation and clarity of vision and purpose. There are no stereotyped solutions, but sharing information and an understanding of the operational realities and the regulatory perspectives will help.

Appendix – Relevant extracts from the Insolvency Act 1986

122. Circumstances in which a company may be wound up by the court

(1) A company may be wound up by the court if:

(a) the company has by special resolution resolved that the company be wound up by the court,

(b) being a public company which was registered as such on its original incorporation, the company has not been issued under section 117 of the Companies Act (public company share capital requirements) and more than a year has expired since it was so registered

(c) it is an old public company, within the meaning of the Consequential Provisions Act

(d) the company does not commence its business within a year from its incorporation or suspends its business for a whole year

(e) except in the case of a private company limited by shares or by guarantee the number of members is reduced below 2

(f) the company is unable to pay its debts

(g) the court is of the opinion that it is just and equitable that the company should be wound up.

(2) In Scotland, a company which the Court of Session has jurisdiction to wind up may be wound up by the Court if there is subsisting a floating charge over property comprised in the company's property and undertaking, and the court is satisfied that the security of the creditor entitled to the benefit of the floating charge is in jeopardy.

For this purpose a creditors' security is deemed to be in jeopardy if the Court is satisfied that events have occurred or are about to occur which render it unreasonable in the creditor's interests that the company should retain power to dispose of the property which subject to the floating charge.

123. Definition of inability to pay debts

(1) A company is deemed unable to pay its debts -

(a) of a creditor (by assignment or otherwise) to whom the company is indebted in a sum exceeding £750 then due has served on the company, by leaving it at the company's registered office, a written demand (in the prescribed form) requiring the company to pay the sum so due and the company has for 3 weeks there-after neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor, or

(b) if, in England and Wales, execution or other process issued on a judgment, decree or order of any court in favour of a creditor of the company is returned unsatisfied in whole or in part, or

(c) if, in Scotland, the *induciae* of a charge for payment on an extract decree, or an extract registered bond, or an extract registered protest, have expired without payment being made, or

(d) if, in Northern Ireland, a certificate of unenforceability has been granted in respect of a judgment against the company, or

(e) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.

(2) A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

213. Fraudulent trading

(1) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.

(2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying on of the business in the manner above mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper.

214. Wrongful trading

(1) Subject to subsection (3) below, if in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.

(2) This subsection applies in relation to a person if -

(a) the company has gone into insolvent liquidation,

(b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and

(c) that person was a director of the company at that time; but the court shall not make a declaration under this section in any case where the time mentioned in paragraph (b) above was before 28th April 1986.

(3) The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2) (b) was first satisfied in relation to him that person took every step with a view to minimising the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken.

(4) For the purposes of subsection (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both -

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and
(b) the general knowledge, skill and experience that the director has.

(5) The reference in subsection (4) to the functions carried out in relation to a company by a director of the company includes any functions which he does not carry out but which have been entrusted to him.

(6) For the purposes of this section a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.

(7) In this section 'director' includes a shadow director.

(8) This section is without prejudice to section 213.