

**SUBMISSION MADE TO THE
FINANCE PORTFOLIO COMMITTEE**

***Ninth Interim Report of the Commission of
Inquiry into certain Aspects of the
Tax Structure of South Africa:***

***Fiscal Issues Affecting
Non-Profit Organisations***

**SUBMITTED BY THE NON-PROFIT
PARTNERSHIP**

***South African National NGO Coalition
South African Grantmakers Association
Charities Aid Foundation
The Development Resources Centre and
The Legal Resources Centre***

OCTOBER 1999

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1. ACKNOWLEDGEMENTS:

We would like to thank the following organisations and individuals for their participation in the work of the Task Team on NPO Tax, and without whose help this report would not have been possible.

Centre for Policy Studies
 Charities Aid Foundation
 Douglas and Velcich
 Environmental Development Agency
 European Union Foundation for Human Rights
 Ford Foundation
 ICCO
 Johannesburg Child Welfare
 Interfund
 Ithuba and Ubuntu Trusts
 Charles Stewart Mott Foundation
 Non-Profit Partnership
 Rural Development Services Network
 SA Federation for Mental Health
 SA Grantmakers Association
 SANGOCO
 South African Council of Churches
 United Community Chests of South Africa (UCCSA)
 Wits Foundation

Our funders: Interfund, EUHRF, CS Mott Foundation

Special thanks also goes to Zane Dangor and Ntibi Maepa of the Development Resources Centre; Mary Honey of the Legal Resources Centre; Leon Isaacson of the Community Chest ,Cape Town; Eugene Saldanha and Laura Maxwell - Stuart of The Non-Profit Partnership; Legi-Link and Joe Louw.

If there are any queries or any additional copies of this report are required, please contact:

Laura Maxwell Stuart
 Non Profit Partnership
 Tel: 011 403 7746
 Fax: 011 403 8703

E-mail: laurams@sangoco.org.za

EXECUTIVE SUMMARY

Response to the Ninth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa: Fiscal issues Affecting Non-Profit Organisations

1. Introduction

The Non-Profit Partnership and its allies the South African NGO Coalition, the Charities Aid Foundation (CAF), and the SA Grantmakers Association (SAGA) - have called for changes to the current tax regime in South Africa to be implemented urgently.

We welcome the publication of the Katz Report and support many of its recommendations and suggested amendments to the Income Tax Act.

Indeed, the Report recognises the vital role played by the non-profit sector, and among other recommendations, reiterates our call for two important changes to the current legislation:

- That Public Benefit Organisations (PBOs) as defined in the legislation be exempt from paying income and ancillary taxes - necessitating the amendment of Sections 10 (1) (f) and 10 (1) (fA) of the Act; and
- Enlarging the scope of the current Section 18A of the Act by reference to a scheduled listing of qualifying organisations and activities.

In the main, the Report is supportive of the general submissions made by SANGOCO and its allies in the Non-Profit Partnership. However, we believe the Katz report is wanting in some respects and have spelt out our suggestions in the section of our submission dealing with specific proposals.

2. Economic Policy and NPO Tax

Social and development needs cannot be provided by the State alone; international experience shows a high correlation between private giving and tax benefits for non profit organisations. Both South African and international findings show that the non profit sector is a major contributor to employment, economic growth and gross domestic product.

South Africa's business sector commits significant financial and other support to social development, but this has been skewed in favour of educational institutions qualifying for Section 18A donor deductions. Greater tax incentives for donors would lower the cost and encourage higher levels of donations to NPOs and direct funding to a broader range of national needs and priorities.

3. The Commission's Findings

The Katz Report acknowledges the "*virtual unanimity of opinion and authority regarding the importance and justification for retaining the privileged tax status of NPOs and extending the ambit and reach thereof.*"

The Katz Report also supports the view of a wide range of non-profit and business organisations who have supported - *in written endorsements to this committee* - our view that a more favourable tax regime for non profits will, rather than reducing the financial capacity of the fiscus, increase the capacity of civil society to participate in reconstruction and development and reduce demands on the state.

The Katz Report supports this policy position in so far as it recommends a range of amendments and exemptions to the present Income Tax Act.

4. Specific Proposals

- 4.1 Objective Criteria:** We support the proposal that the subjectivity of the present system should be replaced by one which is objective and clearly defined as to eligibility criteria.
- 4.2 Defining characteristics of tax exempt NPOs:** We support continued compliance with the provisions of the Non-Profit Organisations Act of 1997 for the purposes of ensuring minimum standards for NPO governance, accountability and transparency.
- 4.3 Excessive levels of remuneration:** We believe that as a "safety check" the recommendation should be rephrased to accommodate the common law concept of "reasonable remuneration".
- 4.4 Expending 75% of net revenue accruing in the previous tax year:** We propose this clause should be omitted as it mitigates against NPOs becoming financially self-sustaining.
- 4.5 Eligible public-benefit activities:** Human Rights organisations have been excluded from the list. Also we believe it will be helpful for the list to be left open by the inclusion of "***or similar activities.***"

- 4.6 Interest income derived from capital donations:** We propose that the legislation clarifies that interest income derived from capital donations is not considered trading income.

- 4.7 s18A and differentiation as to scale of benefits:** Firstly, propose, as a first option, broadening Section 18A of the Act to include all exempt PBOs as defined. Should this not be accepted, we propose a broadening of Section 18A to include, at the very least, PBOs whose objects and activities focus on the alleviation of poverty and the provision of services and social and economic development services to impoverished and disadvantaged areas and people. Secondly, we propose that the list of criteria for Section 18A qualifying PBOs be certain and a matter of law. Thirdly we propose that if it is recommended that donor deductions be subject to “specific limits” over and above the 5% cap for all taxpayers, we propose the issue requires further clarification and discussion.
- 4.8 Calculating loss to the fiscus:** We strongly support this recommendation.
- 4.9 Trading income:** We accept the recommendation that no tax implication should arise in respect of “trading income” up to a limit of R100 000 or 5% of gross receipts, subject to it being reviewed when more research information becomes available.
- 4.10 Donations tax:** We propose that the phrase “disinterested benevolence” be excluded from the definition.
- 4.11 Estate duty deductions:** A list of organisations in respect of which bequests will be deductible from estate duty should be the same as the list of income tax exempt PBOs referred to in clause 6.1.3 of the Katz Report as amended in terms of these proposals.

The Partnership supports and calls for the immediate implementation of the policy principle adopted by the Report, which recognises the importance and justification for retaining the privileged tax status of NPOs and extending the ambit and reach thereof.

**RESPONSE TO THE NINTH INTERIM REPORT OF THE
COMMISSION OF INQUIRY INTO CERTAIN ASPECTS
OF THE TAX STRUCTURE OF SOUTH AFRICA:
FISCAL ISSUES AFFECTING NON-PROFIT ORGANISATIONS**

October 1999

Prepared by The Non-Profit Partnership (NPP), a partnership between the South African National NGO Coalition (SANGOCO), the South African Grantmakers Association (SAGA) and the Charities Aid Foundation (CAF) and its affiliates the Development Resources Centre (DRC), and the Legal Resources Centre (LRC).

1. Background

Organised non-profit organisations (NPOs) have been calling for an enabling legal and fiscal environment for many years. Indeed, the Independent Study into an Enabling Environment for NPOs (commissioned by the DRC in 1992) identified tax benefits as a key component of such an enabling environment. The findings of the Independent Study formed the basis for an intensely consultative process country-wide, where NPOs articulated their concerns and proffered their recommendations regarding necessary changes with support from legal experts who drew on comparative international research. These consultations and discussions enabled The Non-Profit Partnership to consolidate its recommendations to the Katz Commission from a well-researched position.

2. **Response to the Katz Commission**

The NPP facilitated a discussion on the Ninth Interim Report of the Katz Commission of Inquiry into certain Aspects of the Tax Structure of South Africa: Fiscal issues Affecting Non-Profit Organisations..

In principle, the group's reception of the Katz Report was positive. It was encouraging to note that the Report incorporated a number of the key recommendations made to the Commission by the South African National NGO Coalition and its affiliates, the Charities Aid Foundation and the SA Grantmakers Association. However, the Report was found to be wanting in certain respects, particularly as regards recommendations on donor deductibility.

3. **Economic Policy and NPO tax**

3.1 **Policy Arguments in Favour of Tax Benefits for Civil Society**

It is widely acknowledged that civil society, of which the non-profit sector forms a significant part, are essential for democracy and development and that the social development needs of modern societies cannot be provided by the state alone. Indeed, the country's development needs can only be addressed through collaborative partnerships between the state and civil society.

International experience shows a high correlation between private giving and tax benefits for NPOs and their donors. Tax benefits are the effective tools of a tax policy which acknowledges that harnessing private resources for the public benefit is cost-efficient for government because the private resources mobilised far exceed the financial loss to the fiscus and the capacity of the government to similarly use the revenue collected for the public benefit. (Sangoco, 1998, p9). Indeed, international research shows, and recent South African research has indicated, that the non-profit sector is a major contributor to employment, economic growth and gross domestic product, (ibid, p9).

The South African business sector commits significant financial and other support to social development. Recent research shows that the corporate sector accounts for between 15% and 34% of the NPO funding base. The research also shows that Corporate Social Investment has been skewed in favour of educational institutions qualifying for Section 18A donor deductions. A broadening of this Section 18A will facilitate the flow of Corporate Social Investment funds to other priority development sectors such as health, rural development and employment creation. (ibid, p4). Broader tax incentives for donors would lower the cost and encourage higher levels of donations to NPOs, thus mobilising the civil society resources so essential for democracy and development.

3.2 The Katz Report

The Katz Report acknowledges the *“virtual unanimity of opinion and authority regarding the importance of and justification for retaining the privileged tax status of NPOs and extending the ambit and reach thereof.”*

The Katz Report supports this policy position insofar as it recommends:

1. Exemption of public benefit organisations (PBOs) as defined in the legislation from payment of income and ancillary taxes. This would necessitate the amendment of the current exempting provisions, namely, Sections 10 (1) (f) and 10 (1)(fA) of the Income Tax Act 58 of 1962 as amended (the Act.)
2. Tax deductions for donors by enlarging the scope of the current Section 18A of the Act by reference to a scheduled listing of qualifying organisations and categories of activities. The Katz Report recommends that the amount of the deductions be limited to 5% of taxable annual income and/or that a system of partial deductibility is introduced until such time as the Commissioner installs a computer system which can calculate and monitor the cost of the deductions to the fiscus. It is envisaged that this system could allow for some differentiation as to the scale and quantum of benefits so that the government can give differential or preferred encouragement to particular social priorities at different times.
3. Exemption from income tax on “related trading” activities to the extent that it does not exceed 50% of gross receipts.
4. Exemption from income tax on “unrelated trading” activities to the extent that it does not exceed the greater of R100 000 or 5% of gross receipts per year and if conducted within a separate structure.
5. Rescinding the existing restrictions upon categories of permissible investments by tax-exempt organisations.

6. Exemption from donations tax for any donations of property to an institution which enjoys an exemption from income tax in terms of the recommended new Section 10(1)(f) of the Act.
7. Exemption from estate duty by calling for the implementation of the earlier recommendation of the Fourth Report of the Katz Commission. The Fourth Report recommended that the amount of a bequest made to any organisation listed by Government Proclamation, which will be composed with reference to socially and economically beneficial organisations, will be tax-deductible from the estate duty payable.

However, from the perspective of practical application, with the exception of 3.2.5 above, the recommendations of the Katz Report require fine tuning and/or further attention to practical detail.

4. **Proposals for Change**

We support and call for:

- 4.1 **The immediate implementation of the policy principle adopted by the Katz Report which recognises “*the importance of and justification for retaining the privileged tax status of NPOs and extending the ambit and reach thereof.*”**
- 4.2 **The immediate implementation of the Katz Report recommendations referred to in 3.2 above as modified in terms of the following specific proposals.**

5 Specific Proposals

5.1 Objective criteria - Clause 6.1.2

That the subjectivity of the present system should be replaced by one which is objective and in which eligibility criteria are clearly defined.

We support this recommendation and propose that the amending legislation should limit administrative discretion in so far as reasonably possible.

5.2 Defining characteristics of tax-exempt PBOs - Clause 6.1.3

5.2.1 *(ii) formal registration in terms of the Non-Profit Organisations Act No 71 of 1997; and continued compliance with its conditions and disciplines;*

We support this recommendation for the purpose of ensuring minimum standards for NPO governance, accountability and transparency.

5.2.2 *(v) the application of the major portion of “gross receipts” for philanthropic purposes; and not merely to benefit members of staff or for some limited category of beneficiary/ies;*

The phrase “and not merely to benefit members of staff or for some limited category of beneficiary/ies”, is too narrow in meaning and could exclude many NPOs which are considered to be PBOs. For example:

Many NPOs are membership organisations, and have, therefore, as their main purpose, the promotion of their members’ work. This purpose is also describable as ‘public-benefit’ work. An example

would be a membership organisation's work to strengthen members to enable them to work more effectively.

Would the application of the organisation's major proportion of gross receipts in this way be regarded as having been for public benefit purposes?

Many NPOs provide services such as training, education and development support to disadvantaged communities. Such NPOs incur primarily office administration and salary costs to enable them to provide such public benefit services. Surely it is not intended to exclude such NPOs from the definition of PBO?

We propose the above phrase should be reworded as follows: "*The application of gross receipts for public benefit purposes.*"

5.2.3 (vi) *a prohibition on the payment of remuneration to employees in excess of levels which in the opinion of the Commissioner are excessive, having regard to norms and standards applicable to NPOs from time to time.*

The group recognises and appreciates this proposal as an attempt to minimise the abuse of tax benefits as envisaged in the tycoon employee syndrome for example. However, there are some inherent problems with this prohibition. Firstly, remuneration of employees is strictly a governance issue and is not the province of, nor should it be left to the discretion of, a public official. Secondly, it is difficult to say what norms and standards apply to the sector as different organisations will have quite widely differing salary scales, depending on their work and their governance. Thirdly, there is a worldwide move towards self-sustainability for the non-profit sector and ways are being devised to make this a reality.

Usually, this will involve the use of highly professional skills to generate income for an organisation. Organisations, therefore, should be allowed leeway to compete with the business sector in terms of salaries to be able to attract the necessary professional skills.

It is suggested, rather, that NPOs should be required to account for salaries within their normal reporting and accounting obligations in terms of the NPO Act.

We propose that as a ‘safety check’ the recommendation should be rephrased to accommodate the common law concept of ‘reasonable remuneration’. This term ‘reasonable compensation’ is used in the NPO Act. The use of the ‘reasonable’ concept would therefore accommodate the concerns raised by both the Commission and the NPO sector.

1. *(vii) an obligation to expend, in any particular year, at least seventy-five percent (75%) of net revenue accruing in the previous tax year, save in so far as the Commissioner may approve the expenditure of a lesser percentage for reasons and purposes approved by the Commissioner.*

If NPOs are unable to accumulate reserves they remain dependent on the short-term generosity of funders. This mitigates against NPO financial planning and sustainability. Clearly a funder is entitled to stipulate how funds should be utilised. It is submitted that this matter should not be subject to the discretion of an external body.

We propose that this provision is omitted.

5.3 Eligible public-benefit activities – Clause 6.1.4

Although the criteria for eligible public-benefit activities is extremely inclusive, the group suggests that there has however been one omission and that is **‘human rights organisations’**. We believe, given the importance of human rights, that it should be added to the list as a separate category and not just as a subsidiary of “politics, public policy and advocacy.”

Further, we propose that the list be left open by the inclusion of an ‘or similar activities’ clause.

5.4 Interest income derived from capital donations

Also of importance to the financial sustainability of NPOs is their capacity to earn interest income from capital donations (sometimes referred to as ‘passive’ income). The report does not indicate whether such interest income would be considered trading income unrelated or related. This is of practical importance considering the tax-exempt limits recommended for related and unrelated NPO trading.

The earning of such interest income is not derived from a trading activity which provides competition to tax-paying commercial interests.

We propose that the legislation clarifies that interest income derived from capital donations is not considered trading income, even to the extent that it causes income to exceed maximum permissible levels.

5.5 s18A and differentiation as to scale of benefits – Clause 6.1.7

That the ambit of the benefit of donor deductibility [] be substantially enlarged to a scheduled listing of organisations and categories of activities which would qualify for this benefit. The system could allow for some differentiation as to the scale or quantum of benefits on the basis that government may wish to give differential and preferred encouragement to particular social priorities at different times. Recognising concerns expressed with regard to the difficulty of anticipating the likely impact this concession might have on future tax receipts, it is proposed that specific limits be established at this stage, which could be reviewed from budget year to year. Should there be concern that this recommendation would involve too great a loss of revenue, the proposal in the respect of partial deductibility contained in paragraph 5.14.11 could be considered. [please also see clause 6.1.8]

The clause is not clear about whether the differentiation as to the quantum of benefits should be allowed before or after there is a general widening of s18A. The group emphasises the need for a general, across-the-board expansion of the ambit of this section to allow donor deductibility beyond educational institutions and which is not subject to changing government priorities. Lack of certainty around this issue will inhibit NPO planning for financial sustainability. Beyond across-the-board expansions, the government could give preferred encouragement to particular social priorities as an added benefit.

The latter half of the clause also requires further clarification because it is not clear whether the "specific limits" being referred to are the 5% cap;

partial deductibility; a pro rata share of a limited fixed amount to be determined by the state or a combination of any of the three.

As a first option, we propose a general broadening of Section 18A of the Act to include all exempt PBOs as defined in the amended legislation.

Should our first option not be accepted, as a second option, we propose a broadening of the existing Section 18A to include, at the very least, PBOs as defined, whose objects and activities focus on:

- * the alleviation of poverty;**
- * the provision of services and social and economic development services to impoverished and disadvantaged people and/or areas.**

We also propose that the list of criteria for Section 18A qualifying PBOs be certain and a matter of law.

Finally we propose that if it is recommended that donor deductions be subject to “specific limits” over and above the 5% cap for all taxpayers, we propose the issue requires further clarification and discussion.

5.6 Calculating loss to the fiscus – 6.1.9

That an efficient computer system be introduced so as to calculate the cost of such deductions to the fiscus.

South Africa has no mechanism for determining the actual loss to the fiscus as a result of tax deductions and exemptions to non-profit organisations. This has often been used by the SA Revenue Service as an excuse not to accept evidence that is provided by the international community that the loss to the fiscus is insignificant compared to the gains in social and economic development.

We strongly support the recommendation to introduce a mechanism for calculating the cost of not only deductions but exemptions. We also note that should budgetary constraints prevent the installation of such a monitoring mechanism, grant funding could, no doubt, be accessed from civil society sources.

5.7 Trading income – Clause 6.1.11

5.7.1 *(i) on the basis of the ‘de minimis’ rule, no tax implication should arise in respect of such “trading income” up to a limit of say R100 000 p.a., or 5% of ‘gross receipts’, whichever is the greater.*

It appears that this clause is referring to unrelated income, but it is not actually clear. Evidence has shown that, on the whole, an organisation does not ever recoup more than five to ten percent in direct cost recovery (USAID research on NPO Sustainability, 1998). It would be preferable to at least allow organisations the option to save more through unrelated trading activities.

We accept this recommendation, subject to it being reviewed once research information on how the provision affects the sector becomes available.

5.7.2 (ii) *income derived from ‘related trading’ or fee generation be exempt from tax, to the extent that the gross receipts derived from such income-generating activities do not exceed one half of the gross receipts (including donations) of the organisation concerned. The balance would be subject to normal principles of taxation.*

We accept this recommendation, subject to it being reviewed once research information on how the provision affects the sector becomes available.

5.8 Donations tax – Clause 6.2.2

The Commission recommends that the statutory definition be amended to accord with that of the common law. Donations should thus be defined as a transaction whereby one person, without any obligation to do so, undertakes, out of disinterested benevolence, to give property to another person without receiving anything in return.

It is very rare to find a transaction where donations are made with ‘disinterested benevolence’. There is usually some motive of direct or indirect personal gain, e.g. improved public relations or tax deductions. It would, therefore, cause unnecessary hindrance to those wishing to donate should this definition be adopted.

We propose that the phrase “disinterested benevolence” is excluded from the definition.

5.9 Estate Duty deductions – clause 6.3.3

For purposes of consistency and clarity, we propose that a list of organisations in respect of which bequests will be deductible from estate duty be the same as the list of income tax exempt PBOs referred to in Clause 6.1.3 of the Katz Report as amended in terms of these proposals.

6. Discretionary Powers

Discretionary powers should be as limited as far as reasonably possible, whether they are vested in the Commissioner or the NPO Directorate. This is the principle to which the NPO Act adhered. However, when such powers are required, it may be more appropriate that discretionary powers that do not require expertise in tax issues be lodged with the NPO Directorate in the Department of Welfare which will have more capacity to look into and regulate the sector. This is, as a matter of fact, the reason the Directorate was established. The report itself emphasises administrative simplicity for SARS personnel [pg 7: 5.4.1].

7. Conclusion.

Clearly, there is a need for increased collaboration between the Department of Welfare and the SA Revenue Service. The question of who should hold the powers to make certain decisions is of key importance, and can only be resolved through dialogue between State departments themselves, as well as between these departments and representative organs in civil society.

In conclusion, The Non Profit Partnership and its affiliates welcomes the broad approach to changes made in the Katz Report. However, as stated it is important to take into consideration the proposed amendments suggested in this document. Without such changes it is possible that the legislation could continue to discriminate against many public benefit organisations. We would be willing to collaborate, and in a working group tackle some of the points in finer detail.

References Used in the Research

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Letters of Endorsement for The Non Profit Partnership Submission

- The AIDS Consortium
- Alliance for Micro Enterprise Development Practitioners
- Association for Rural Advancement *
- Community Agency for Social Enquiry
- Co-operative for Research and Education
- Disabled People South Africa
- Eastern Cape NGO Coalition
- European Union Foundation for Human Rights *
- Free State NGO Coalition
- GANGOCO
- IDASA
- Joint Education Trust
- Kagiso Trust
- Kwa Zulu Natal NGO Coalition
- Legal Resources Centre *
- National Children's Rights Committee
- National Community Radio Forum
- National Land Committee
- National Progressive Primary Health Care Network
- Northern Province NGO Coalition
- National Welfare Social Service and Development Forum
- Northern Cape NGO Coalition
- Operation Hunger
- Pretoria and District Child and Family Welfare Society
- Project Literacy
- Rural Development Services Network
- South African Congress for Early Childhood Development
- South African Council for Child Welfare *
- South African Institute of Fundraising
- South African National NGO Coalition
- South African Training Institute for Early Childhood Development
- United Community Chests of South Africa (UCCSA)
- Urban Sector Network
- Women's National Coalition

* *Denotes letters of support which have also been sent independently as submissions.*

Copies of the actual letters of endorsement are available for perusal from the Committee Clerk, Mr Andre Hermans or contact Legi-Link at 461-0229 (Nadine Weber).

