

Third Sector Organizations in Germany: Legal Forms and Taxation

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I. INTRODUCTION

Historically, legislation concerning associations and foundations in Germany has been part of the Civil Code (Bürgerliches Gesetzbuch) since the end of the 19th century. Legislation on Third Sector Organisations (TSOs) is found in different laws; for example, the Constitution, the Commerce Law, the Civil Code, and so forth. Contrary to other European systems, the German system views the legal existence of TSOs in two separate spheres: civil law and tax law. The legal form of existence for TSOs under civil law is generally not related to tax issues found under tax law. For this reason, the universal expression "NGO" cannot be applied to German law without losing its meaning. For purposes of this paper, however, the term "NGO" will be replaced by the term "TSO" to indicate legal persons with tax advantages.

In 1995 an estimated 1.4 million full-time jobs existed in the German TSO sector, which accounted for 5% of all employment in Germany. The Third Sector was dominated by health and social services, each of which covers one-third of the entire sector. During the years 1990 to 1995, employment in the third sector increased by an additional 14%.

II. PROVISIONS OF THE GENERAL LAWS

A. Consistency and Clarity of the Laws

Germany is a federal state with the national *Bund* and 16 federal *Laender*. Consequently, there is no single overall regulation for TSOs. For example, the law for foundations is governed by the legislative powers of the 16 *Laender*. The *Laender* also regulate other juridical persons.

The basics of the federal system are that the national (*Bund*) law overrules state (*Laender*) law. If there is a contradiction between the national provisions on TSOs and those in *Laender* law, the national law will be binding (except in case of foundations).

The fact that TSOs have to comply with laws and regulations concerning the different types of organisation forms on the one hand as well as with the different tax laws ruling all types of organisations on the other hand, makes the management of TSOs a difficult task, especially when TSOs offer services in different fields at the same time. Difficulties, however, also arise with the public administration (registration courts, revenue services). As a result TSO related issues form a growing part of litigation in all instances of Germany's jurisdiction. Another result, of course, is a growing number of private counselling services, accompanying and qualifying TSO leaders.

B. Constitution

According to the German Constitution, TSOs are generally guaranteed the same basic rights as natural persons, if the basic rights are applicable to juridical persons according to their nature. For example, provisions concerning the protection of family cannot be applied to TSOs. But TSOs may rely on the freedom of speech, the right of assembly, and so forth. In general these rights are accorded to domestic juridical persons only. These provisions are applicable to foreign organizations, if their action field is inside the German territory and if they maintain administrative links to Germany.

The freedom to establish associations and societies is stated explicitly in the Constitution whereas the right to establish a foundation is not. However, despite no explicit statement of this right, foundations are guaranteed the same basic rights as other legal persons.

Any restriction on TSO rights is generally permissible for reasons of national security and public safety.

C. Types of Organizations

According to German law, the notion of public benefit relates to tax law and not to civil law. So the tax law defines, which organizations are de jure corporations. Only these entities can be tax

benefited TSOs. As a consequence all types of juridical persons such as associations, foundations, limited liability companies, and stock companies can be used to create a TSO. The legal forms that are used the most in the sector of TSOs are associations and foundations. The upcoming legal form is the limited liability company – GmbH. In contrast to the tax law, the civil law does not differentiate between legal persons that pursue public benefit purposes and those who pursue private or mutual interests.

1. Associations

An association is an organization founded by at least two (for non-registered) or seven (for registered) members who voluntarily assemble in order to pursue a common purpose. An association may not be established for short periods only. According to German law, there are two types of associations; registered and non-registered. The registered associations are legal persons with full legal ability. In addition, registered associations have the characteristics of limited liability companies with regards to their executive organs. Non-registered associations, on the other hand, are corporations with possible tax concessions under German tax law but without full legal personality. It is for this reason that most associations choose to register even though registration is not mandatory. A registered association is identified by an "e.V." (*eingetragener Verein*) at the end of its name. Associations are primarily regulated by sections 21 to 80 of the German Civil Code.

2. Foundations

Foundations in the sense of the German law are entities with legal personality, whose assets are used to pursue a specific purpose laid down by the founder. Foundations are regulated by sections 81 to 88 of the Civil Code and within the laws of the *Laender*.

From growing importance are foundations set up by a fiduciary contract only, which states purpose and decision making processes. These foundations are lacking full legal personality, are not registered and are not under official control but may enjoy the same tax privileges like registered foundations.

3. Limited Liability Companies (GmbH)

These are entities that are founded by one or more persons wishing to pursue a common legal purpose. The shareholders insert the initial stock and are generally not liable beyond their share. Thus, the liability is restraint to the company's assets. GmbHs are regulated by the law on limited liability companies (GmbH) and more generally, by the commercial code (HGB).

4. Stock Companies (AG)

Founders of a stock company provide the initial capital. In exchange, they get a corresponding number of stocks, entitling them to a certain portion of the company. The founders usually hold 51% of the stocks to guarantee decision-making power for themselves. AGs are regulated by the stock companies law (AktG) and more generally, by the Commercial Code.

5. Other Types of Organizations

Political Parties are regulated separately from other associations in section 21 of the German Constitution. Their legal status is controversial. Some say that they are not associations at all. The prevailing opinion considers political parties to be unregistered associations, such as trade unions, so that they don't have legal status as juridical persons. However, political parties are not considered part of the TSO sector.

Germany has a huge number of umbrella organizations that follow TSO issues. The most important are the "Big Five" so called "Wohlfahrtsverbaende" – Welfare Associations (Caritas, Diakonie, Rotes Kreuz, Arbeiterwohlfahrt, Deutscher Paritaetischer Wohlfahrtsverband). They negotiate with state officials in order to write contracts that are binding for the state as well as for the associations and umbrella organizations. Further, these umbrella organizations receive financial contributions of which they distribute to their members.

D. Purposes of TSOs

German law provides a wide range of freedom for TSO activities. In order to receive tax concessions TSOs have to pursue charitable purposes, purposes of public benefit, or aim for the

promotion of religious entities considered to be legal entities under public law.

Charitable purposes are those that support people who are:

- due to their psychological or psychical condition, dependent on the help of others; or
- economically needy.

Economically needy people are those whose income is not higher than four times the amount of public relief. This principle cannot be applied to people with assets that could be used to amend their subsistence. They are not considered economically needy as long as their fortunes have not been compensated.

Activities that are considered charitable are for example :

- charitable homes;
- telephone care of souls;
- care for handicapped;
- care for people with cancer, mental diseases or HIV;
- women's refuges;
- homeless shelters; and
- public nutrition centers.

Public benefit purposes are those that support:

- science and research;
- education and formation;
- art and culture;
- religion;
- international understanding;
- (economic) aid to developing countries;
- the protection of the environment, landscape and monuments;
- German "*Heimatgedanke*" (a specific form of patriotism);
- youth;

- elderly people;
- the public health system;
- the welfare-system;
- sports;
- the general support of democracy;
- cultivation of plants and breeding animals;
- allotment gardener;
- traditional customs including, Carnival, Shrove Thursday and Shrove-tide;
- care for soldiers and reserves;
- radio amateurs;
- activities with model airplanes; and
- dog sports.

In some cases, charitable and public benefit purposes appear to be identical, but the distinction is that persons who donate money to organizations with charitable purposes, can deduct 5 to 10% of their contributions, which form the bulk of the revenues. In addition, members of charitable organizations can deduct their membership fees.

Purposes that promote the religious entities are:

- the building, decoration and maintenance of churches and parish houses;
- the execution of divine services;
- the training of clergymen;
- the execution of religious instruction;
- funerals and the care of cemeteries;
- the management of the church's assets;
- the payment of clergymen and employees;
- the provision for their old-age and handicap pension; and
- the provision for their widows and orphans.

In order to receive tax concessions, registered associations, foundations, AGs and GmbHs must exclusively establish for purposes like those mentioned above.

E. Registration or Incorporation Requirements

The registration requirements differ according to the type of legal entity used for the creation of the TSO.

1. Associations

In order to get registered, associations must not have the purpose to pursue business operations and must have at least seven members, natural or non natural, domestic or foreign. These members will elect a board that may contain several members, but according to the law, only one person is required.

A statute must be written, stating the mission, name, location where the association will be headquartered, and an acknowledgement that the association will apply for registration. In addition, the statute may contain provisions regarding membership, membership fees, formation of the board, procedures for convening the general assembly, and the required majorities for the assembly and the board in their decision-making processes. The statute must be signed by at least seven members.

The board applies for registration in court by presenting the original statute, a copy of the statute, and a copy verifying the minutes of the founders' first meeting. The registration application should also contain information on the association's name, place of residence, the day of the statute's formation, and the names of the board members. In addition, the application should state how each board member might represent the association in outside relations.

Once the court accepts the registration application, the letters "e.V.", which stands for registered association, are added to the association's name. The association will then be added to the register of associations by the court.

Registration may be rejected if the registering court holds that the papers presented are not sufficient according to the law. The court must provide a substantive reason for rejection, which can only be based on formality questions, for reasons of illegal purpose or public safety or if the association's purposes are considered as economic. The association has the right to appeal against the rejection.

When a board changes, registration of the new board is required. In addition, foreign and non-natural persons can be founders and members, and are equal to natural German members regarding their institutional rights.

There is no capital required for associations, even though it may be recommended. Registration fees depend on the actual value of the association. At a value of € 3000 i.e. , the registration fee will be €52.

For unregistered associations, there is no control by the state during the establishment process. It is sufficient to follow normal procedures (i.e. creating a board, writing a statute, etc.) in order to become an unregistered association. Consequently, however, unregistered associations don't obtain legal entity status. For that reason, most TSOs organize themselves as registered associations. Registration, however, is not required.

Associations that are composed by only or mainly foreign members can be established, but are under specific regulation that provides easier methods for interdiction.

2. Foundations

Foundation are formed by the endowment and the official admission by the competent state authority in the state where the foundation wants to have its seat.

The endowment has to include the binding declaration by the founder that he devotes a certain asset to the completion of a specific purpose.

The founder has to draw up the foundation's statutes that have to include provisions on the name of the foundation, its seat, its purpose, its asset and the formation of the board.

The competent state authority has to recognize the foundation as a legal person, if the legal requirements are met, the purpose can be pursued permanently and the purpose does not endanger the common welfare.

Even though the law states no minimum capital the asset have to be adequate in order to pursue the objectives determined by the founder. In practice the authorities require an asset value of at

least € 50.000. The assets can consist of any item of value yields profits and need not necessarily consist of money.

State officials' rejection of admission must be given for substantial reasons. Once a rejection has been issued, the foundation is given time to amend the papers that were considered insufficient.

The foundation may also appeal against the decision.

Registration fees depend on the foundations' assets.

For non-registered foundations, see below.

3. Limited Liability Companies (GmbH)

To establish a GmbH only one founder is required. The founder may also be a foreigner or a non-natural person. A founding document must be written by the founder(s). If there are several founders, they all have to agree and sign the founding document before a notary public in order to establish the company. The document must include the name, location, purpose, amount of initial capital, and the amount each partner contributed.

The liability capital must be at least €25,000. If there are several founders, each one has to give at least one-quarter of his investment to get the company registered. The smallest amount that is required by each founder is €100. If the company should be limited in time or if the partners should have other duties apart of their investments, it must be stated in the statutes as well. The capital may also be composed of items of value.

The company's governing instrument must be certified by a notary public and filed with the Commerce Register after handing it to the district court located in the district where the company is seated.

The fees needed for the creation of a GmbH are calculated according to the cost regulation (KostO). They vary depending on the value of the GmbH, the number of purposes etc. However, the statutes may foresee, that all creation costs will be taken over by the company itself once established. In order to do so, the contract must provide the maximum amount that will be overtaken. Usually, for companies with an initial capital of € 25.000 creation costs will be about € 1.500.

4. Stock Companies (AG)

AGs share similar requirements as GmbHs for establishment procedures. At least one founder, natural or non-natural, foreign or domestic, shall create a founding document and sign it before a notary public. The statute must state the name, location, purpose, amount of base capital, the type of stock that is distributed, whether the stocks are to be issued to the owner or to a name, the requisite number of board members, and the rules as to how that number is determined. Another document must be signed by the notary public which includes the founders' names, the type of distributed stocks, and the amount of base capital.

The base capital must be at least €50,000. The registering procedure is the same as for GmbHs. The court reviews the application for conformity to procedures. If the information given by the companies is incorrect or insufficient, the court may reject the registration. An appeal is permitted.

The registration application consists of the name, location, purpose, amount of initial capital, the day of the statute's establishment, and the board members' names. If there are special provisions regarding the period of existence or capital, they must be stated in the application as well.

The remarks made concerning the creation costs of a GmbH are in general also true for the creation of an AG.

F. Charitable Organization Register

Currently, there is not a register that contains information on all the TSOs operating in Germany.

Registered associations are entered into the association's register, commercial entities into the Commerce Register. The registers are maintained by the district courts. There is no national association's register or Commerce Register serving the entire Republic.

Foundations are registered by the Ministries of Justice. There is no central register for foundations.

Regulations concerning the register are within the competence of the *Laender*.

The registers consist of applications and documents submitted during the registration procedures.

They are open to public.

Republic wide registers exist only in hands of private organizations. For example the German Association of Foundations disposes of an index of foundations in Germany, <http://www.stiftungsindex.de/deutschland.htm>.

G. General Powers

TSOs that have legal entity status may exercise all general rights and powers of juridical persons such as ownership of real property or entering into contracts. In addition, they can sue or can be sued.

Any prohibition of TSOs is regulated in the Constitution and in a separate law that is extended to the other juridical persons. A TSO may not pursue purposes or exercise activities that are in contradiction with the criminal law, that are directed against the constitutional order or that are against the idea of international understanding. In such instances, the state has the duty to dissolve the TSO.

In addition, TSOs that consist mainly or exclusively of foreign members or exercise political activities may be prohibited if the interior or exterior state security or the public order or other important issues of the German nation or one of its *Laender* are threatened or violated.

In order to avoid prohibition of the TSO itself, officials in charge may reduce the prohibition to the execution of certain activities or to certain persons working for the TSO.

H. Membership Organizations

According to German law, only registered associations are considered legal persons among membership organizations. Civil law societies and unregistered associations may exist, but they are not legal entities and thus have limited legal capacity.

Usually membership within associations starts with the entry and is terminated upon death, exclusion or resignation of the member. There is no right to become a member of an association,

whereas the law provides every member with the right to leave the association. All procedures have to be in accordance with the association's statutes.

III. GOVERNANCE

Associations must have a general assembly and a board of directors elected by the assembly. Provisions affecting these two organs must be included in the statute. Internally, these provisions have the quality of binding rules.

The assembly should meet at least once a year. Democratic principles must be applied in its decision-making process. Additional provisions must be stated in the statute.

The board is the legal agent of the association. It represents the association in and out of court.

For a foundation, a board of directors is required. It has the same function as the board of an association.

The share-holders that establish a GmbH must elect a managing director to lead the GmbH and represent it in external relations determined by the share-holders. The assembly supervises the activities of the managing director and is empowered to dismiss him or her. The assembly's rights and duties and those of the managing director may be specified within the statute if it is not considered an imperative provision.

The general assembly of the AG, where all stockholders gather, elects a supervisory board. The election power is related to the number of stocks that is held by the voting person. This supervisory board appoints the members of the executive board. The supervising board has the task to control the executive board. The general assembly must meet at least once a year.

IV. DISSOLUTION, WINDING UP, AND LIQUIDATION OF ASSETS

The dissolution of an association may be decided by the general assembly or may occur at the end of the period for which the association was established. Dissolution may also be initiated by the

state if less than three members are left. If the association is dissolved, the legal agent(s) must inform state officials of the event. If it is dissolved by the state, it can no longer continue with its activities. When an association is dissolved because of illegal activity prohibited under law, the highest *Laender* office or the Ministry of Interior of the *Bund* exercises full authority. In such instance, the *Laender* or the Ministry of Interior of the *Bund* will confiscate the association's assets. If an association declares bankruptcy, the organization will be removed from the register. A GmbH and an AG can be dissolved by the decision of the shareholders or in case of insolvency.

Regardless of the reasons for dissolution of tax exempted organizations, their assets must be distributed to other not-for-profit organizations. Distribution may also be made in favour of public legal persons. The recipient must use the assets for public benefit purposes. If not, state officials will recall the organization's tax exemption retroactively for ten years. In this light, when an association seeks tax exemption, the statute must contain provisions on how the assets should be distributed in cases of dissolution.

If a GmbH or an AG is dissolved, only the assets that were contributed from each share-holder shall be redistributed. A founder of a foundation cannot receive back the endowment he contributed.

V. REGULATION

Generally, tax authorities supervise the expenses made by the TSOs with regard to conformity to their purposes when annual tax reports are handed in. If TSOs fail to hand in their reports, they risk losing their tax benefits. If non-fiscal infringement is detected, the report is handed to the Ministry of Internal Affairs of the *Land* or the *Bund*. The Ministry is empowered to restrict or even dissolve the association if necessary.

In addition to tax control for foundations, there is a supervisory body in each *Land* that is supposed to guarantee the execution of the founder's will. The provisions concerning this regulation are laid down in *Laender* law, so they may differ from *Land* to *Land*. The regulation is primarily directed to the registration procedures and to the further supervision of activities executed by the foundation in

conformity with the founder's will and with the law in general. Foundations are often under less significant control if the state officials consider the internal supervision to be effective and sufficient. Tax reports are generally considered to be private, protected by the Constitution, thus the public is not authorized to access these reports.

VI. FOREIGN ORGANIZATIONS

A. Registration

In order to register, foreign organizations must fulfil the same requirements as domestic German organizations. Foreign associations or associations that consist mainly or exclusively of foreign members, are prohibited from engaging in political activities whereas domestic organizations are simply restricted from such activities. The dissolution of these associations is made easier in sense that the law foresees additional circumstances in which the dissolution may be enforced. The provisions are not applicable to associations that have their seat in the EU or that consist mainly or exclusively of EU-citizens. These associations have to be treated equally to German associations.

B. Foreign Grants

There are no special provisions concerning foreign grants. They are treated like those from domestic donors.

VII. MISCELLANEOUS

Mergers of TSOs are generally permitted. In a merger, an TSO dissolves and its assets as well as their members, if there are, merge with those of another TSO to form a new TSO.

In membership organizations, the members must agree to the merger. Members of the transferring organization are guaranteed the same rights as the members of the receiving one. If the statute already provides rules on merger, the rules should be applied. Under the law, the decision to merge must be supported by at least three-quarters of the members. If, due to the merger, the

purpose changes, all the members have to agree to the changes. The merger must be verified by a notary public and the board of the receiving TSO applies for registration.

Restrictions for the investment of TSOs abroad do not exist. TSOs may invest if it is considered necessary to fulfil statutory purposes. In addition, TSOs will not lose their tax exemptions if they invest parts of their property for asset management.

Besides lobbying, campaigning, and political education, TSOs may neither engage in direct political activities nor raise money or divert money for political parties. However, TSOs may assume a position on a political issue or be close to political parties.

VIII. TAX LAWS

As stated before, all the different types of TSOs are ruled by the same regulations for tax exemptions.

A. Tax Concessions

Tax concessions for TSOs are granted if they pursue the purposes mentioned above, regardless of the type of organization, provided the organisation falls under the Corporation Tax Act.

1. Forms of tax

German tax legislation comprises a wide range of different tax forms. In the present context, however, only corporation income tax, commercial earnings tax and turnover tax (VAT) are of interest.

1.1 Corporation income tax

Corporation income tax is one of the forms of tax on gains, and is levied on the profits of a corporation. The rate of tax comes to 26.5%. Associations benefit from a tax-free amount of € 3835. Profits in one business year may be set off against losses in the previous year or subsequent years.

1.2 Commercial earnings tax

Commercial earnings tax is likewise levied on profits. It is a municipal tax. Consequently the rate of tax varies between the various municipalities of the federal state. The rate of tax ranges between 0% and 20%. In respect of commercial earnings tax as well, associations benefit from a tax-free amount of € 3835. Losses may only be set off against profits from subsequent years. Commercial earnings tax is accounted a business expense, and reduces the net profit assessed by corporation tax and commercial earnings tax itself.

1.3 Turnover tax / VAT

The regular rate of turnover tax / VAT comes to 16%. For some specific products (foodstuffs, books etc.) and services (local transport services, theatre and concert functions etc.) a tax rate of 7% applies. A whole range of services is exempt from turnover tax / VAT. This applies above all to services in the fields where organisations of the Third Sector are active (education, health, culture).

2. Tax privileges

Alongside the laws governing the various individual forms of tax – the Income Tax Act [Einkommensteuergesetz], Corporation Tax Act [Körperschaftsteuergesetz], Turnover Tax / VAT Act [Umsatzsteuergesetz] etc.) and the code of proceedings for fiscal courts, German law includes a special tax statute of general application, the Fiscal Code [Abgabenordnung]. In the Fiscal Code the basic concepts for tax purposes are defined (tax, assessment, residence, business premises etc.), the responsibility of the tax authorities and the obligations of persons liable for tax and their representatives are laid down, the procedures for the levying of tax and for compulsory enforcement are described and the prescriptions for tax penalties and fines are set forth. A separate section of the Fiscal Code is dedicated to “tax-privileged objectives”. This section contains 19 paragraphs (§§ 51 to 68), and describes the fundamental rules governing tax privilege. The specific effects of tax privilege, on the other hand, are described in the individual tax laws. In the following account, the fundamental principles of tax privilege and their specific effects in tax terms will be dealt with in an integrated manner.

2.1 Tax-privileged objectives

In accordance with German tax legislation, only corporations that come under the Corporation Tax Law and are based within Germany may claim tax privileges (there is an upcoming discussion, whether this conflicts with EU regulations to secure competition among EU based enterprises). This has two important consequences: first of all, unincorporated firms do not qualify for tax privileges, and secondly, all of those corporations that come under the Corporation Tax Law – the association (registered or not), the company with limited liability, the public limited company, the foundation (registered or not) and the cooperative society – do so qualify. The crucial factor in the first instance is that these corporations should pursue objectives that are of benefit to the community, or charitable or church-related objectives as defined by the Fiscal Code.

2.1.1 Objectives of benefit to the community

A corporation is regarded as pursuing objectives of benefit to the community if in the material, intellectual or moral sphere it acts disinterestedly to promote the good of the general public. As special examples of objectives of benefit to the community, the Fiscal Code mentions

- the promotion of science and research, education and training, art and culture, religion, good understanding between nations, development aid, environmental conservation and the preservation of the national heritage.
- the promotion of juvenile welfare, help for the aged, public health, social welfare and sport
- the general promotion of democratic political institutions in the Federal Republic of Germany
- the promotion of animal and plant breeding, of the Carnival, of amateur radio and model aeroplanes.

2.1.2 Charitable objectives

A corporation is considered to pursue charitable objectives, if its activity is directed to the disinterested support of persons

- who in view of their physical, mental or emotional state are dependent on the help of others, or

- whose earnings do not come to more than four times the regular rate of social security benefit and who own no assets that may be used to support them.

2.1.3 Church-related objectives

A corporation is considered to pursue church-related objectives if its activity is directed to the disinterested support of a religious community provided that this community is a corporation under public law. To church-related objectives belong, for example, the building and maintenance of churches, the giving of religious instruction, the management of church assets, funeral services and the care of funerary monuments.

2.2 Disinterestedness

Corporations that qualify for tax privileges are subject to the requirement of disinterestedness.

They

- may not pursue, as a prime aim, objectives tending to their own profit
- may use their resources only for objectives in keeping with their articles of association
- may not pay out any profits
- may not pay disproportionately high salaries
- must make use of their resources early, e.g. within a limited period of time (within the year following on the inflow of the resources).

Shareholders of joint-stock companies that enjoy tax privilege, and members of other tax-privileged corporations, may not, when they leave or when the corporation is dissolved, receive more than the capital share that they have paid into it.

On the dissolution of the corporation, or if the objectives on which its tax privileges are based cease to exist, its assets, in so far as they exceed the sum of the capital shares paid into it, may only be used for tax-privileged objectives. The assets may, to this end, be bestowed on another tax-privileged corporation, which in turn must make use of it for tax-privileged objectives.

If the restrictions on the assets of the tax-privileged corporation that have just been described are not plainly established in its articles of association, no tax privileges will be granted. If the relevant stipulations in the articles of association are revoked or modified in such a way that the required restrictions on corporate assets are no longer found, then they are regarded as having been absent from the beginning, with the consequence that tax privileges for ten years will be revoked, with retrospective effect. The consequence is the same if the corporation fails, in the course of its practical business activities, to adhere to the restriction on corporate assets that has been established in its articles of association.

2.3 Exclusivity and immediacy

The tax-privileged corporation must, in keeping with its articles of association, pursue tax-privileged objectives exclusively, and must fulfil these objectives in an immediate way. This means that the corporation's articles of association may not include any other non-tax-privileged objectives alongside the objectives that qualify for tax privilege, and the corporation may not promote its objectives merely in an indirect manner, but must do this directly and in an immediate way. An exception to the requirement of immediacy is found in the "promotion societies", the objective of which may consist in supporting another tax-privileged corporation in a material or non-material sense. Foundations are likewise allowed to carry out their activities as a promotional foundation without themselves being active.

2.4 Formation of reserves

Tax-privileged corporations may form reserves if these reserves are needed in order to put the corporation in a future position where it will be able to pursue its objectives in keeping with the terms of its articles of association. The reserves must be tied to a specific objective (purchase of a building for purposes to do with the corporation's objectives, financing of investments and projects etc.).

Tax-privileged corporations may also form "free reserves". These reserves are free in that sense, that they are not necessarily to be spent within a certain time period, but can be kept until the dissolution of the corporation. Whenever they are spent, however, they have to be spent in accordance with the statutes of the corporation. Free reserves may only be used for the strengthening of the assets of the corporation, and are not subject to the requirement of short-term application of resources. The formation of free reserves is limited, however. In a single year

- a third of the surplus derived from the management of assets
- and 10% of the other resources that are to be used in the short term

may be put into a free reserve fund.

C. Donations and Sponsoring

At the present time, when financial resources from governmental sources are being cut back, tax-privileged organisations are increasingly coming to depend on private resources for the financing of their activities. Fiscal encouragement of private donations is therefore of great significance for the development capacity of the entire sector of tax-privileged corporations. In the German system of income tax, corporation tax and commercial earnings tax, donations reduce the taxable income only to a limited extent.

At present the following regulations apply:

- in the case of donations for church-related, religious, scientific and charitable objectives and objectives especially deserving of support that benefit the community, a proportion of up to 5% of the total amount of taxable income, or 2% of the sum deriving from turnover and personnel costs, may be claimed as tax-exempt
- in the case of donations for charitable and scientific objectives and cultural objectives that are especially deserving of support, this amount is increased by another 5% of the total amount of taxable income
- individual donations of € 25,565 and over may be spread out for tax purposes over a period of seven years

- in the case of donations to tax-privileged foundations, up to € 20,450 may be deducted from tax
- in addition to the possibilities of tax reduction just mentioned, in the case of donations that are paid into the assets of a foundation on the occasion of its being set up, up to
- € 307,000 may be claimed as tax-exempt income; the amount may be spread out over a period of ten years.

By contrast with donations, where it is a condition that the recipient of the donation should not supply any service to the donor in exchange, in the case of sponsoring we always find an exchange of services: the sponsor pays for a service that he receives. For the sponsor it is a case of business expenses. This is in the interest of the sponsor, seeing that the business expense is not taken into account, for taxation purposes, only to a limited extent – as is the case with the donation – but to the full amount.

For a tax-privileged corporation, in connection with a sponsoring relationship, various different forms of income may be found:

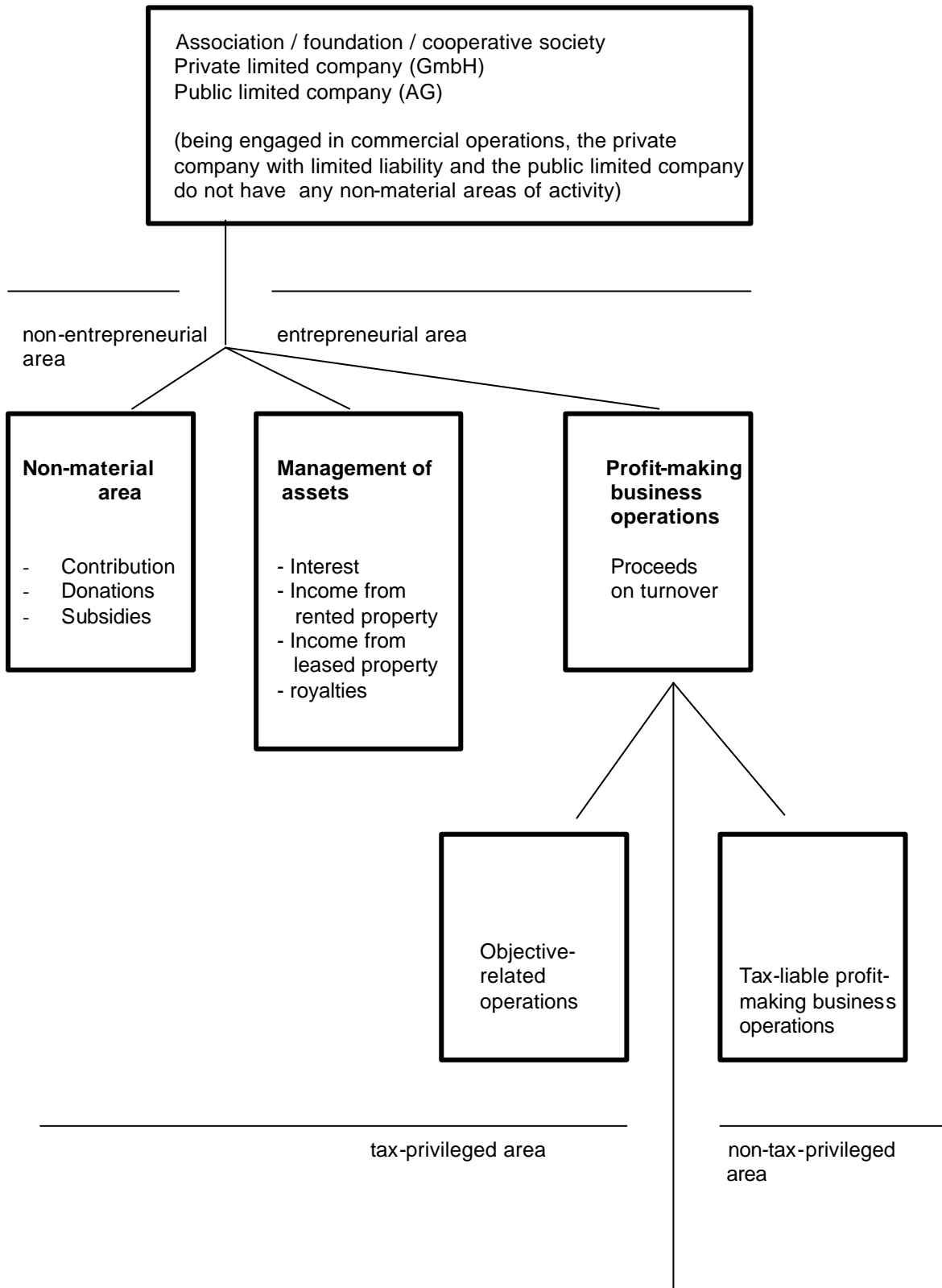
- If the tax-privileged corporation supplies the sponsor with a service in the form of promotion, then we have a taxable profit-making business operation. In this case a profit totalling an overall of 15% of the sponsoring sum will be assessed. This is liable for both corporation and commercial earnings tax. In addition, VAT at the regular rate (currently 16%) will be payable.

If the sponsor pays the tax-privileged corporation in recognition of his being entitled to use its name and/or logo, then the relevant income of the tax-privileged corporation is allocated to assets management. There is no liability for corporation tax or commercial earnings tax, and with VAT the reduced rate will be applied. With the objective of transforming taxable income from promotion into tax-privileged income from asset management, the tax-privileged corporation may, for a fee, transfer the tax-privileged promotional rights to an advertising agency as an intermediary. The agency will then, in its own name and at its own risk, conclude contracts with the individual companies involved. The tax-privileged corporation will charge the company for the transfer of

rights and receive tax-privileged royalties, while the same royalties will reduce the taxable income of the company as expenses.

D. Commercial Activities

Tax-privileged corporations finance their activities from a range of different sources. Depending on the legal form, they may have recourse to members' contributions, donations, subsidies or yields on assets. With the development of Third Sector organisations into service suppliers in the social and cultural spheres, remuneration for services rendered has also become an important source of income for tax-privileged corporations. The following diagram shows the distinctions between the various forms of income of tax-privileged corporations, in accordance with tax categories:



1. Areas of activity of tax-privileged corporations

1.1 The non-material area (ideeller Bereich):

Here the tax-privileged corporation is active in keeping with the objectives set down in its articles of association, and does not supply any services against payment. It receives members' contributions, donations and subsidies, which it spends in the fulfilment of its constitutional objectives. For associations this is the area which may be represented through a simple accounting of income against expenditure.

1.2 Asset management (Vermögensverwaltung)

In the context of asset management, the tax-privileged corporation receives interest which is exempt from income tax, as well as profits on rented and leased property (immovable assets). In so far as in the context of sponsoring it exploits rights in the use of its own name, it receives income from licences (royalties), which is likewise exempt from income tax. Seen from the point of view of turnover tax / VAT, the corporation is active in an entrepreneurial way in the context of its asset management. In so far as its performances here are not exempt from turnover tax / VAT, the reduced turnover tax rate falls due which at present comes to 7%. This applies, for example, to profits from licences.

2. Profit-making business operations (wirtschaftlicher Geschäftsbetrieb)

In the context of their profit-making business operations, tax-privileged corporations obtain payment (turnover) for the services they supply. Through their profit-making business operations they participate in the events of the market, and stand in a competitive relation to non-tax-privileged market principals. The tax treatment of the profit-making business operations of tax-privileged corporations depends on the question whether the given profit-making business operation can be seen as an "objective-related operation" or not. Objective-related operations are privileged, both for income tax and for VAT purposes. Profit-making business operations that are not objective-related operations will be subject to tax as non-tax-privileged enterprises.

3. Objective-related operations (Zweckbetrieb)

In § 65 of the Fiscal Code there is a formulation of the requirements that must be found if an activity is to be seen as an objective-related operation. The profit-making activity must in its every aspect support the corporation's objective as expressed in its articles of association, its profit-making business operations must be necessary for the fulfilment of its constitutional objectives and may stand in a competitive relation to non-tax-privileged companies only to the extent that this is unavoidable for the fulfilment of its constitutional objectives. On account of the difficulty of discriminating between objective-related operations and profit-making business operations, there are frequent confrontations on this head between the corporations established for purposes of benefiting the community and the tax authorities.

Objective-related operations are, for example:

- a) the cultural function of an arts society for which an entrance fee is charged
- b) the workshop of a society for the promotion of professional training for which attendance fees are charged
- c) the help and counselling given to young people for which the Jugendhilfe GmbH [Juvenile Welfare Co. Ltd.] of the municipal juvenile welfare authority makes charges (cost unit rates): such operations may not be financed through subsidies, as the individual young person has a statutory or legal claim on assistance, and the municipal juvenile welfare authority has commissioned the Jugendhilfe GmbH of our example to give counselling)
- d) the restaurant of a society that looks after the interests of people suffering from mental illness, if the restaurant is only operated for the purpose of giving the society's clients an opportunity of work for therapeutic ends.

In its objective-related operations, the tax-privileged corporation is not subject to corporation tax or commercial earnings tax. For profits achieved in the context of objective-related operations, therefore, no tax is payable. With VAT the reduced rate applies. Some objective-related operations are completely exempt from VAT (educational functions, objective-related operations of welfare

syndicates and their member organisations, if their services are supplied at a lower charge, than those supplied by non-tax-privileged providers).

4. Taxable profit-making business operations

With its profit-making business operations that are non-objective-related, tax-privileged corporations as well are subject to corporation and commercial earnings tax. With VAT the current regular rate of tax applies. Examples here are too numerous to be classified: the bar of a sports club, the provision of rental cars, the drawing up of expert reports, the holding of bazaars and lotteries. The following points, however, should be noted:

- a) if the income from taxable profit-making business operations does not exceed € 30,678, no corporation or commercial earnings tax will be levied.
- b) for associations, cooperative societies and foundations, independently of their tax privileges and only on the basis of their legal form (in that they are not joint-stock companies), an exempt amount of € 3835 deductible from profits earned is allowed for corporation and commercial earnings tax.

5. Subsidiary companies of corporations that benefit the community

Tax-privileged corporations may also have a participating interest in joint-stock companies. This also applies in cases where these joint-stock companies are not tax-privileged. The participating share in the company is allocated to asset management, provided that the tax-privileged parent company doesn't exert a determining influence on its concrete business decisions. The foundation of subsidiary companies is always a sensible move for an association if in the context of objective-related operations its constitutional activities have attained a bulk that is too large for the structure of the association to handle (the subsidiary company will then likewise be founded as a tax-privileged company), or if taxable activities, in view of their extent, threaten its tax privileges. In this case the bar of a sports company, for example, may be managed by the subsidiary company.

In the foundation of subsidiary companies it is a question of the greatest importance where the tax-privileged parent company has obtained the resources for the formation of the capital of the subsidiary company. The tax-privileged corporation may only use its own resources for the formation of capital if these have already been put into a free reserve fund. This point is not all cases viewed too strictly by the tax authorities, but always would be in a case where the company being founded was not tax-privileged.

E. Reporting

Tax exempted TSOs have to periodically report their activities to the tax authorities. Every three years, the tax authorities reviews the tax exemption. Narrative and written financial reports are required. Rules for reporting contributions to TSOs do not exist.

In Germany the responsible tax authority is solely responsible for the concession and control of tax privileges. There is no separate procedure in German tax legislation for the establishment of a right to tax privileges. The right to privileged treatment will be established in the context of regular tax assessment: in place of a tax assessment for corporation and commercial earnings tax, the tax-privileged corporation will receive a "notification of exemption". This notification exempts the corporation from the taxes which would fall due. If the corporation is also liable for corporation and commercial earnings tax in view of its taxable business operations, it will receive the usual tax assessment along with an annex stating that in other respects it is exempt from these taxes.

As tax demands can only be remitted for trading years that have expired, the tax privilege in consequence will in all cases only be granted with retrospective application. For the first, and generally also for the second trading year, the corporation will receive a "provisional certificate". This establishes only the fact that the corporation is pursuing tax-privileged objectives in accordance with its articles of association, and that it is entitled to make out donation certificates with effect on its tax liability.

Tax-privileged corporations are obliged to draw up statements of their end-of-year accounts. The form of these accounts is based on the legal form of the corporation. In addition to these accounts,

tax-privileged corporations are obliged to submit reports on their activities for each trading year, from which it may be seen in what ways the corporation has attained its constitutional objectives.

To make matters easier for tax-privileged corporations, an assessment of tax liability (or possible exemption) is made for such corporations as a rule only at intervals of three years. In view of the risks to which commercially active tax-privileged corporations are exposed, however, they will certainly endeavour to submit annual tax statements and thus receive annual notifications of exemption as well.

In the context of the tax assessment period (four years), fiscal auditing may be carried out by the tax authority, in the course of which the conditions for the concession of tax privilege will again be checked. It may be a result of such audits that the tax assessment will be changed to the disadvantage of the tax-privileged corporation, and even that the tax privileges for the auditing period will be revoked with retrospective effect.

Foundations are subject to separate rules because of their endowments, which are under control by both tax authorities and their supervisors. In addition, foundations must present an annual financial work plan detailing their future activities.

F. Miscellaneous

According to German regulations law, it is not allowed, that the expenses of the TSOs administration including the fundraising activities exceed a reasonable level. The evaluation will be made by comparison of the expenses and the income and depends on the individual case.

But, however, according to the relevant application decree the level is exceeded when the a TSO, widely financed by donations, uses its assets predominantly for administrative costs and not for the realization of the tax benefited statutory purposes.

Exceptions are made if the TSO is still in the building phase.

Special accounting rules exist only for associations. If an association's income does not exceed a certain limit and if it does not engage in commercial activities, the association need only account

for their receipts and expenditures. All other forms of TSOs have to present their reports in the form of a balance sheet.

IX. COMPLIANCE

TSOs that violate the law may be punished by the competent authorities. A violation of the criminal law provisions or the Constitutional order may lead to the confiscation of the TSO's assets.

X. GOVERNMENT FUNDING

TSOs are permitted to compete for government funds in free and open competitions for which there are bidding rules. They can also seek access to government funds through unsolicited proposals for grants and contracts. In addition, the government permits TSOs to bid to become recipients of certain assets the organization seeks in order to privatize, recognizing that support can be given to private organizations. Government assets and funding do not wind up disproportionately among TSOs formed or controlled by the government or particular officials, e.g., QUATSOs--quasi-TSOs, or GOTSOs--government organized TSOs.

XI. PRIVATIZATION

Labour market policies have led to a privatization by outsourcing governmental institutions into private membership organizations.

XII. CONCLUSIONS

The majority of Third Sector organisations in Germany are tax-privileged and endeavour to continue to conform to the criteria that will enable them to retain their privileges. With the shift in the basis for financing, especially for organisations of the cultural and social sector, the position of these Third Sector organisations in relation to tax privileges is likewise changing. The withdrawal of the government from the financing of cultural projects and the diminishing governmental subsidies for social work projects has forced many organisations into a cooperative partnership with commercial companies that see the sponsoring of culture and social causes as a new opportunity

for communicating with and acquiring customers. A partnership with commercial companies, however, is only possible for tax-privileged corporations to a limited extent, if their tax privilege itself is not to be endangered. In particular, organisations in the cultural sphere are consequently more and more inclined either to work in twin structures of tax-privileged and non-tax-privileged corporations, or else to decide from the very beginning against applying for privileged status. In the social sector similar tendencies are to be observed at the present time. The future of tax privilege in Germany will therefore depend on the way in which the conditions for the financing of projects change in the fields of activity that are relevant for Third Sector organisations. Here the question occupying the foreground will be whether the extension of the fiscal recognition of donations can more effectively compensate for the reduction in governmental spending than an increased cooperation between the organisations of the Third Sector and the commercial sector would be able to do. It will also be a matter of significance whether cultural and social services especially will remain on the whole a specific field of activity for tax-privileged organisations, or whether these fields of activity, in the course of further economies and deregulation measures, will be developed as regular fields of activity for the private commercial sector.

Berlin, September 2004